

**The Political Economy of the Accession Process:  
Aspirations of European Union Membership leading to  
Divergence within Central and Eastern Europe**

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The content of this PhD is entirely my own work and has been composed by me. Any mistakes or omissions are the responsibility of the author.

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## **ABSTRACT**

This thesis examines the Political Economy of the Accession of Central and Eastern European Countries to the European Union. It focuses on the process of accession from the perspective of the applicant countries and the constraints they face. For this purpose the thesis examines the literature of transition economics with a particular emphasis on macro-economic modelling and contrasts the findings with literature on the accession process. It demonstrates that there is a need to apply the transition literature to the accession process by using economic modelling. The thesis recognises that the position of the applicant countries is path dependent and thus sets out the main historical developments. The thesis demonstrates that groups of applicant countries share a certain degree of common historical development, particularly in the later half of the second century. The thesis then examines the transition up to date with a particular emphasis on the relationship with the European Union, to determine the starting point of the accession process. This part of the thesis shows that some of the countries have fallen behind in the accession process and face further difficult reforms. The next section of the thesis models the accession process and derives theoretical conclusions. The conclusions show that constraints play an important part in the accession process. In particular the thesis identifies the main constraints as political feasibility, time consistency and uncertainty. Furthermore the theoretical conclusions demonstrate that countries at different stages of the accession process need to pursue different strategies. The thesis then applies the theoretical conclusions by examining the literature on the applicant countries to identify the presence of constraints. The thesis demonstrates that the constraints are present in all the applicant countries, but, as predicted by the theoretical model, the presence of constraints is most frequent in those countries furthest away from accession. The thesis concludes that some countries face an increasingly difficult accession process, which might lead to the postponement or even abandonment of accession.

## CONTENT

TITLE PAGE	p. 1
ACKNOWLEDGEMENTS	p. 2
ABSTRACT	p. 3
CONTENT	p. 4-5
STRUCTURE OF THE THESIS - SCHEMATIC CONTENT	p. 6
INTRODUCTORY QUOTES	p. 7-8
INTRODUCTION	p. 9-13
Chapter 1: Literature Review	p. 14-40
a) Economics of Transition	<i>p. 14-35</i>
b) Literature on the Accession Process	<i>p. 36-40</i>
Chapter 2: Historical Development	p. 41-89
a) Issue Definition and Country Classification	<i>p. 41-48</i>
b) Early History and First World War	<i>p. 49-57</i>
c) Inter-war period and Second World War	<i>p. 58-64</i>
d) The Cold War	<i>p. 65-79</i>
e) The Revolutions	<i>p. 80-89</i>
Chapter 3: Reforms and the West	p. 90-139
a) Economic reforms and political change	<i>p. 90-119</i>
b) Relationship with the European Union	<i>p. 120-139</i>

Chapter 4: The Model	p. 140-233
a) Issue definition	p. 140-159
b) The Model	p. 160-165
c) Political Feasibility	p. 166-179
d) Complementarities	p. 180-191
e) Time Inconsistency	p. 192-204
f) Uncertainty	p. 205-211
g) Endogenised Choices	p. 212-227
h) Results of the theoretical analysis	p. 228-233
Chapter 5: Evidence of Economic Constraints	p. 234-275
a) Evidence of constraints in the applicant countries	p. 234-241
b) Winners and Losers?	p. 242-270
i) Evidence for all applicant countries	p. 242-247
ii) The Baltic States	p. 248-250
iii) Bulgaria	p. 251-253
iv) The Czech Republic	p. 254-255
v) Hungary	p. 256
vi) Poland	p. 257-259
vii) Romania	p. 260-264
viii) Slovakia	p. 265-266
ix) Slovenia	p. 267-268
x) Summary	p. 269-270
c) The Way Ahead	p. 271-275
CONCLUSIONS	p. 276-279
APPENDIX A	p. 280-285
APPENDIX B	p. 286-292
GLOSSARY OF TERMS AND ABBREVIATIONS	p. 293-298
BIBLIOGRAPHY	p. 299-316

## STRUCTURE OF THE THESIS - SCHEMATIC CONTENT

	Introduction
	Literature Review (Chapter 1)
EARLY HISTORY ↓ Balance of Power ↓ WORLD WAR I ↓ Independence and Dictatorship ↓ WORLD WAR II ↓ Superpower Confrontation ↓ COLD WAR ↓ Soviet Dominance ↓ REVOLUTIONS ↓ Transition and the EU ↓ ACCESSION PROCESS ↓ Winners and Losers ↓ MEMBERSHIP ???	<div>Historical Development (Chapter 2)</div> <div>Reforms and the West (Chapter 3)</div> <div>The Model (Chapter 4)</div> <div>Evidence of Constraints (Chapter 5)</div> <div>Conclusions</div>

## INTRODUCTORY QUOTES

### Scenario 1: Triumphant Markets

**“The countries of Central and Eastern Europe, Cyprus and Malta all joined between 2005 and 2008”**

(Scenarios Europe 2010, p. 17).

### Scenario 2: The Hundred Flowers

**“Faced with this new set of hurdles, only four countries managed to stay on course and join the Union. The other applicant countries were weakened for years to come: exhausted by fifteen years of sacrifice and economic injustice, their populations were no longer prepared to listen to promises of a brighter future. Reforms stagnated, economic activity and investment ran out of steam, and Central and Eastern Europe sank into long-term economic and political instability”**

(Scenarios Europe 2010, p. 25-26).

### Scenario 3: Shared Responsibilities

**“The European Union, for its part, is still in the process of digesting the recent enlargement towards Central and Eastern Europe... : between 2004 and 2009 thirteen new states have joined the Union”**

(Scenarios Europe 2010, p. 34).

#### Scenario 4: Creative Societies

**“The result was a delay in enlargement: the first Central and Eastern countries did not join the Union until 2008 and negotiations with the others are likely to take a few more years yet. The Union particularly tarnished its reputation by its blatant disregard for the applicant countries: while its social and environmental demands became stricter from one European Council to the next, it failed to introduce new aid mechanisms and its Central European partners inevitably perceived the new criteria as further pretexts for delaying their accession”**

(Scenarios Europe 2010, p. 41).

#### Scenario 5: Turbulent Neighbourhoods

**“The eastern parts of the continent are permanently destabilised by Russia: organised crime’s hold over the leading elites continues to grow, there is ongoing conflict between central government and the regions and the economy is in a parlous state”**

(Scenarios Europe 2010, p. 48).

*Quotes taken from the discussion paper of the European Commission’s Forward Studies Unit by Bertrand, Michalski & Pench*

## INTRODUCTION

When in 1989 the revolutions of Eastern Europe swept away the communist regimes, it became clear that a new era in European history had begun. It showed that one of the most ardent wishes of these new democracies was to belong to the most successful process of international relations - the economic integration of a large number of diverse economies within the European Union. In particular, ten Central and Eastern European Countries (CEECs) applied to join the European Union as soon as possible - Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Romania, Poland, Slovakia and Slovenia<sup>1</sup>. But, as yet, the outcome of this process is unknown. The quotes preceding this introduction give an indication of the range of possible outcomes.

After the transformation in Central and Eastern Europe (CEE) at the end of the 1980s, one of the first questions to emerge was whether there was a place for these countries in the existing international organisations of Western Europe. In particular, the wish of some of these countries to belong to the European Union (EU) was voiced soon after the communist regimes disintegrated. After the initial enthusiasm of both the countries of CEE and the Western European states, it became clear that the difficulties of this radical change in the political and economic geography of Europe were vastly underestimated. These difficulties still crucially influence the relationship between the countries of Europe and not only make the timing of accession doubtful, but may even make accession impossible if not addressed in the near future. Thus, it is of extreme importance to analyse the given difficulties and to suggest policy options to remove the obstacles to further integration in Europe.

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<sup>1</sup> Cyprus, Malta and Turkey have also applied, while recently Croatia has moved towards application since the death of Tudjman, the nationalistic president of Croatia (frontier-free Europe, 2000).

The thesis uses a political economy framework, because one of the crucial features of the transition process is the interaction of politics and economics. Paul Hare notes:

“Even more so than in more settled and developed economies, there are few aspects of economic policy in transition economies that can be fruitfully and comprehensively discussed without making some reference to their political configuration” (p. 11, 1992).

An emphasis is also placed on the historical development of the accession applicants to ensure that they are understood in context:

“Serious judgements about the spectacular failure of the communist regimes can be arrived at only after thoroughly analysing the social and economic realities in Eastern Europe in historical context ... On the basis of such analysis it is possible to draw conclusions about socio-economic policies for the reconstruction of the societies and economies of these countries” (Teichova, p. 19, 1997).

The applicant countries face a difficult transformation. Not only do they need to complete the transition process from a communist planned economy to a market-oriented democracy, but they also need to prepare for membership of the European Union (EU). The purpose of this thesis is to analyse the optimal process by which their aspirations can be reconciled with numerous obstacles. The thesis recognises the heterogeneous nature of these countries while emphasising the similarities in the process they face. It will show that numerous differences exist in their historical development, geographical situation, population, current economic situation and their readiness to become full members of the EU. But it will also be demonstrated that they share a number of similarities, which allows the theoretical analysis of the accession process. These similarities can be identified when regarding the historical development of these countries, especially in the avalanche-like process of disintegration of the Communist regimes, which they experienced in the late 1980s and early 1990s.

Furthermore, their relationship with the European Union has been characterised by their similarities rather than their differences. They all face a



very costly process, which will take a number of years. At the end of this process, they hope to be full members of the EU. In the meantime, they can expect to encounter political and economic obstacles on the way to full membership, which might impede the progress of their integration with Western Europe. Some evidence of constraints are apparent, especially for those countries furthest removed from membership. All of the accession countries face a lengthy process, which needs to be managed effectively, in order to achieve the optimal transition to membership. They begin the process from different starting points, given their historical differences, which will make the process more difficult for those applicants furthest from accession.

Chapter 1 of this thesis examines the literature relevant to the accession process. It surveys the literature on the economics of transition with particular emphasis on the macro-economic modelling of a large-scale institutional reform process. This chapter also examines the literature available on the relationship between the European Union and Eastern Europe. More recent evidence of constraints in the literature will be examined in Chapter 5.

To be able to understand the process of accession, it is necessary to understand not only the present economic and political situation but to understand the underlying structure of these countries. Chapter 2 analyses the historical background of the applicant countries, paying particular attention to the Cold War period and the subsequent revolutions. The chapter examines the historical developments leading to the starting point of the transition process to determine historical trends, which might influence the accession process.

Chapter 3 provides a detailed account of each applicant's experience since 1989, highlighting their relationship with the European Union in the last decade. A study will be made of the present economic structure of these countries, which is used to determine the degree of transformation needed to become a member of the European Union. The chapter will provide an overview of the transition process, highlighting problems in the introduction of economic reforms. Chapters 2 and 3 are necessarily detailed in terms of

each applicant's historical development, with a particular emphasis on the second part of the twentieth century. These chapters illustrate how the CEECs have developed to determine the starting point of the accession process. Furthermore, the problems and challenges arising from the historical context still determine many of the underlying economic conditions of the applicants, and, more crucially, many of the attitudes and behaviour patterns of the population are still strongly influenced by the historical context of the applicants.

The fourth part of this thesis will focus on a theoretical examination of the accession process. The literature findings introduced in Chapter 1 are used to construct theoretical models to highlight problem areas of the accession process. A particular emphasis is placed on Political Economy models, which prove to be useful in analysing this interface of politics and economics. This model will identify economic constraints and the interrelation of these constraints with the choices of the applicant countries and the EU.

The findings of the model are examined in light of the present situation of the CEECs in Chapter 5. The recent literature on the applicant countries is examined to identify the presence and prevalence of the economic constraints identified in Chapter 4. This analysis identifies winners and losers of the accession process and possible future developments are suggested.

The conclusions of this thesis draw together the results of the previous analysis. The conclusions identify possible outcomes of the accession process and comment on the current situation of the applicant states. The conclusions comment on the likely outcomes of the accession process, in particular whether and when the different candidate countries will gain full membership of the EU. The thesis thus follows a timeline until the starting point of the accession process. The accession process is then modelled to analyse underlying trends. These findings are then examined in light of evidence from the applicant countries to determine the likely prospects for membership for each of the CEECs.

The structure and methodology of the PhD can be summarised in the following schematic table:

**Table I.1: Methodology of the PhD**

Structure of the thesis	Introduction
Methodological Background	Literature Review (Chapter 1)
Socio-economic Background	Historical Developments (Chapter 2)
Starting point of Accession Process	Reforms and the West (Chapter 3)
Economic Modelling	The Model (Chapter 4)
Application of the Model	Evidence of Constraints (Chapter 5)
Prospects for EU membership	Conclusions

The thesis demonstrates that each of the different strands of methodology, namely the historical development, the initial transition process, the economic modeling and the evidence of constraints, need to be combined to provide a complete understanding of the accession process.

## Chapter 1: Literature Review

### a) Economics of Transition

This chapter focuses upon the economics of transformation. In particular, it summarises the discussion which has been taking place since the CEEC countries committed themselves to establishing a market economy. One of the main debates has been on speed and sequencing of this transformation. This discussion will be particularly relevant to Eastern enlargement of the EU as it can be applied to the process of preparation of these countries for full membership, as well as giving an impression of the current state of economic reform in Eastern Europe. It will also show the difference in attitude from the initial enthusiasm of the CEECs for integration into the EU and the current state of postponement and faltering public and political support in Central and Eastern Europe.

Transition economics has become an important branch of economic theory. This is reflected in the breadth of writing on the subject. The subject is being taught in many universities and excellent textbooks are now available. It is difficult to single out any of these textbooks but "Winds of Change" by Gros and Steinherr, (1995) and "The Economics of Post-Communist Transition" by Blanchard, (1997) are important contributions to the field. A further textbook on transition economics has been written by Marie Lavigne, (1995). In her book she concludes:

"The main 'economic consequences of the East' are still ahead, and ambivalent. The optimists contend that the recession in the East has bottomed out or is soon to do so. Growth in these countries will stimulate the end of recession in the West. The markets will be successfully implemented. The 'green shoots' of the private sector are visible everywhere and will soon be blooming. The pessimist sees a protracted recession, little structural change, and seeds of conflict and disorganisation on top of open wars in some areas of the CIS and in Yugoslavia. Capitalism has won; moreover, it is now free from critics, as the questioning of its failures, in terms of social injustice or inequality in income distribution, can immediately be discarded as a resurgence of communist ideology" (p. 256).

Further literature has been collected by Mark Knell, (1996). In his book, "The Economics of Transition", subjects such as structural adjustment and growth prospects in Eastern Europe are examined.

The main approach to transition economics has been microeconomic theory and empirical modelling. The issues of stabilisation, privatisation and price liberalisation have received particular emphasis. One of the early papers summarising the microeconomic issues in transition economics is "Microeconomics of Transition in Eastern Europe" by Paul Hare, (1990). He highlights the need for market-type institutions to instil confidence in the economy. Furthermore, he shows that it is crucially important to establish a functioning capital market to facilitate economic development, as well as introducing reforms to create a competitive labour market. He concludes that these issues need to be addressed in the context of political constraints:

"There is no doubt that political constraints and the need to set priorities between policies, all of which may well appear to be equally urgent, impose severe difficulties for economic policy" (Hare, p.13).

The problems of the transition process are further explored in Hare's Discussion Paper, "Investment, Growth and Industrial Renewal in the Transition Economies" (1997). Here, Hare identifies some major problems - namely that the CEECs started the transition process with institutions, production facilities and technologies adapted to the centrally planned system. He concludes that current growth rates in the CEECs might not be sustainable and that it is even less likely that the CEECs will achieve the even higher growth rates necessary to catch up with the EU.

Other authors have used microeconomic data to test certain assumptions about key issues of the transition process. For example Konings, Lehmann and Schaffer (1995) have used Polish data to determine job flow patterns, concluding that there are statistically significant differences between the state and the private sector. Hughes and Hare, (1994) used a similar methodology in their paper, "The International Competitiveness of Industries

in Bulgaria, Czechoslovakia, Hungary and Poland". Other papers have also focused on individual issues in microeconomic transition, for example, "A Note on Insider Privatization and Restructuring" by Guzel Bilialova, (1997). Other examples of literature on enterprise restructuring has come from the field of business studies (see for example Dickinson, 2000). A link between the microeconomic transition and EU accession is less common. Another example which charts the result of manufacturing firms in the Czech Republic is "Capital Market Imperfections, Uncertainty and Corporate Investment in the Czech Republic" by Lensink and Sterken, (1999). A paper by Carlin, Estrin and Schaffer, "Measuring Progress in Transition and towards EU Accession. A comparison of manufacturing firms in Poland, Romania and Spain", (1999) shows that Poland is starting to catch up with EU member states, while Romania still has a long way to go.

Apart from enterprise restructuring, another issue, which has been prominent in the transition literature, is trade. As Jim Rollo summarises:

"Since the beginning of transition in Central and Eastern Europe, a considerable literature has grown up on two aspects of the process. First is the role of trade in transition. Typically this literature focused on exchange rate issues, the impact of trade liberalisation at home, and trade barriers abroad. The second aspect is that of enterprise adjustments" (1998).

Jim Rollo himself has greatly contributed to this literature, as well as writing on more general transition subjects. In his paper "EU enlargement and the world trade system" (1995), he examines the effect of EU enlargement on world trade, noting that accession is unlikely to happen quickly:

"The negotiations could not begin before 1997 always assuming a positive Commission opinion – and the earliest date for membership would be around 2000. Malta and Cyprus who already have opinions on their membership may also join at that time. That suggests a post-EFTA enlargement wave of between 4 and 7 countries by the end of the Century" (1995).

As discussed later in this thesis this timetable has slipped substantially with the first accession being likely to happen in 2003 or even later. In an earlier



paper with J. Stern, Jim Rollo examines the economic prospects of the candidate countries and the associated effects on trade. Having constructed an optimistic and a pessimistic scenario he concludes that the pessimistic scenario is more likely:

“The conclusion is that, in this optimistic scenario, the assumed growth rates and the resulting demand for foreign exchange generate foreign private capital inflows on a scale that would seem to be very difficult to achieve ... This means that the best case scenario is unlikely unless domestic consumption is enormously constrained to make way for investment” (1992).

Many of the contributors to the trade debate are collected in a book edited by J. Flemming and J. Rollo, “Trade, Payments and Adjustment in Central and Eastern Europe”, (1992), which includes authors such as P. Aghion, D. Gros, P. Hare, G. Hughes, P. Messerlin, and D. Rosati. The general theme of the book is to extend trade liberalisation, as well as finding mechanisms to integrate the CEECs into the European trading system by finding appropriate institutional arrangements. Alan Winters in his discussion paper, “Who should run trade policy in Eastern Europe and how?”, (1994), examines the institutional factors in trade policy decision making.

An interesting contribution to the macro-economic transition debate is a collection of prize-winning essays on the international finance and exchange rate policies. These essays are collected by the Amex Bank Review awards, edited by Richard O’Brien. They include contributions from authors, such as Gros & Steinherr, Rollo and Seabright. These essays address questions such as exchange rate depreciation after the unification of Germany (Gros & Steinherr in O’Brien, p. 52-67), the effect of exchange rate policy on competitiveness (Seabright in O’Brien, p. 68-78) and the challenge of defining Europe Agreements as either a free trade arrangement or as stepping stones to membership (Rollo in O’Brien, p. 80-92).

Constraints in the transition process have become a more prominent subject of academic literature. A recent paper modelling political constraints

is "The Dynamics of Political Support for Reform in Economies in Transition" by Dani Rodrik, (1995). He concludes:

"if radical reform is endorsed by state-workers at the outset, the same workers will eventually want to slow it down" (p. 22, 1995).

Dariusz Rosati, (1992), goes into more applied detail on the political processes in the transition countries ("The Politics of Economic Reform in Central and Eastern Europe"). He highlights that transition economics is often focused on limited reform programmes and that:

"it tends to ignore the fact that, contrary to initial expectations, the transformation imposes considerable costs on major social groups supporting the transformation" (p.4).

This imposes severe constraints on the political system:

"It all depends on the abilities of the new political elites to carry out the first stage of transformation in a way that will not require too much sacrifice from too many" (ibid. p. 21).

Another example of the problems of political constraints is by Whitefield & Evans, (1994), in "Mass responses to transition and the formulation of political cleavages in Eastern Europe". There are, however, many avenues left to explore. Persson and Tabellini, in "The Size and Scope of Government: Comparative Politics with Rational Politicians" (1999), examine the impact of different electoral systems and processes on the outcomes of government policy and the frequency of corruption - an interesting approach which could be applied to the transition countries.

One of the most startling aspects of the transition process is a large fall in output in the years following transition, which was not predicted by standard macroeconomic models. This clearly indicated that there was something qualitatively different about the process of transition, which could not be explained by standard methodology. An attempt to explain this



phenomenon is made by Roland and Verdier (1997). They link the output fall to the liberalisation of prices - a necessary step in the transition from planned to market economy. The main argument is based on a model, which illustrates the lack of market co-ordination. They conclude that the causes of the output fall can be disruptions of the previously existing production links, falling investment and the absence of replacement investment. Their main result indicates that the disruption of the 'big bang' liberalisation<sup>2</sup> might be necessary in some countries (notably China), but can be avoided in other transition economies. They conclude:

"Here, we show that such a form of gradual liberalization has the effect of smoothing output dynamics and reducing, or even eliminating, the initial output fall after liberalization" (p.13).

Recently, more authors have used macroeconomic models to examine the applicant countries ten years after the transition. Evzen Kocenda (1999) in "Limited Macroeconomic Convergence in Transition Countries" uses a panel unit-root test as an econometric tool. Despite prior expectations, the results show that the transition countries have not converged towards each other. Only the leading transition countries, namely the Czech Republic, Hungary and Poland, show any convergence, while the Baltic States, Slovakia and the Balkan countries are lagging behind. Kocenda concludes that:

"The tests for convergence in macroeconomic fundamentals among the CEE countries show that a limited level of convergence has occurred only for a restricted number of countries at the advanced stage of the transition process" (p.12).

A further examination of the situation in the applicant countries, 10 years after the transition comes from a paper by Tito Boeri, (1999), "Optimal Speed of Transition 10 Years After". He examines the predictions of the Optimal Speed of Transition (OST) theory, in light of the evidence of the last decade. He finds that contrary to initial expectations, transition has involved

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<sup>2</sup> Introduction of all reforms as quickly as possible.

stagnant unemployment pools, large flows to inactivity and low worker mobility. He stipulates that the closure of state enterprises is not a choice variable for the applicants' governments but that this process is determined endogenously in the transition countries. He believes that governments need to use other policy instruments to manage the transition process, namely unemployment benefits:

"Thus it is still necessary to ascertain which policy instruments, if any, can be activated by policy-makers in countries shifting from one economic system to another. The generosity of non-employment benefits is a key variable governments can rather freely adjust particularly at early stages of the transformation process ... and one that has the potential to significantly affect the pace and characteristics of labour market adjustments" (p.15).

A further examination of the policy lessons from the transition process is "Ten Years of Transformation: Macroeconomic Lessons" by Charles Wyplosz, (2000). He maintains that despite problems, the 'big bang' approach was mainly justified, but acknowledges that in many countries the way reforms were introduced did not follow any clear-cut approach. He concludes that the approach chosen has more to do with the feasibility of different approaches than with a pre-decided strategy.

The literature shows that economic models can be applied to the transition process - a methodology Roland and Dewatripont, (1991) pioneered early on in the transition period. This approach tries to capture the essence of the transition process by utilising macroeconomic modelling. Modelling this transition has been attempted by only a handful of writers. A useful paper surveying the literature on macroeconomic modelling is by Duo Qin ("On Macro Economic Modelling of the Transition Process", 1998). He comments on the breadth of literature on transition, in general, yet he laments the relatively limited literature using the modelling approach:

"But so far the literature is dominated by country studies reporting and documenting the reforms ... Textbooks on the subject have also appeared ... Neither country studies nor textbooks are covered by the present discussion.

Instead, it will be focused narrowly upon the nascent and relatively meagre literature which tackles the subject via the formal modelling approach" (Qin, p.4, 1998).

He explains the origin of models, which advocate the 'big bang' approach. Mainly they originated with economic models of disequilibrium. One of many examples of this approach can be found in Blanchard et al (1992) in the paper "Reform in Eastern Europe". Despite favouring a 'big bang' approach, Qin mentions that this approach has severe limitations when applied to the transition economies:

"An outstanding problem of the 'big bang' approach is the likelihood of serious macroeconomic instability caused by severe regime shocks (Qin, p. 5, 1998).

There are few theoretical papers which have formalised a model of gradual transition (e.g. Newbery, 1991). The issue of sequencing has driven developments of these macroeconomic models of transition:

"As far as the impact of various types and sizes of shocks are concerned, another issue has surfaced, namely, the issue of policy sequencing with respect to the optimal speed as well as macroeconomic stability of reforms, since many policy shocks are interdependent, and often complementary with each other, but with different time effects. Pioneer work on this issue has been carried out by Dewatripont and Roland (1992; 1996)" (Qin, p. 5, 1998).

This pioneering work was started by Dewatripont and Roland in "The virtues of Gradualism and legitimacy in the transition economy", (1991). This was followed by the main paper in the field "Transition as a process of large - scale institutional change" (1996). Gerard Roland explored some of these issues in "The role of political constraints in transition strategies", (1994) and "On the speed and Sequencing of Privatization and Restructuring", (1994), which have also contributed to the debate on optimal policies of transition. The 1996 paper is especially important, as it is one of the few papers using macroeconomic modelling in the transition process. Their approach is the

basis of the theoretical modelling used later in this thesis and is explored in some detail below.

They categorise the objectives of the transition process under four different subheadings:

1) *To improve allocative efficiency.*

Allocative efficiency is mainly improved by freeing prices, thus removing the artificial price system created by the planned economies of Eastern Europe. It also has to be mentioned that an attempt to regulate competition has to be made to break-up the large state monopolies, which have often been created in the former communist countries.

2) *To stabilise the macroeconomy.*

Stabilisation includes the attempt to limit inflation and exchange rate fluctuations, as well as attempting to stabilise the Public Sector Borrowing Requirement (PSBR) and the balance of payments. Furthermore, there has to be an emphasis on keeping unemployment as low as possible while reforming the economy. However, too low unemployment can prevent reaping efficiency gains associated with some unemployment. These gains not only come from firms working more efficiently but also from the increase in incentive for people to maintain their employment and thus improve effort and efficiency. C. Shapiro and J. Stiglitz (1984), demonstrate this in their paper, "Equilibrium Unemployment as a Discipline Device". While some unemployment is thus necessary to keep the transformation process moving forward, at the same time unemployment should be kept low to decrease insecurity, loss of human capital, loss of potential output, high burdens on the government budgets and the social costs of unemployment, such as crime and migration.

3) *To provide better incentives to make firms respond to market signals.*

This applies especially to the privatisation process, which allocates ownership to one group or the other. Thus, it will determine which sets of objectives will be used in a firm's future decisions. This also applies to the firms remaining in public hands as the government has to decide whether these firms face

“hard” or “soft” budget constraints. Hard budget constraints refer to a policy by which the credit institutions, if still controlled by government institutions or regulation, do not bail out firms, which are facing financial difficulties and tolerate associated bankruptcies and unemployment. Soft budget constraints mean that the firms do not face a competitive credit arrangement and thus, misallocation of resources in investment decisions will be unavoidable.

4) *To create government institutions “adequate” for a market economy.*

Dewatripont and Roland state that there are different views on “adequate” institutions:

“but there is a relative consensus on a) the need for political and institutional stability b) the need to protect private property rights from encroachment (by government but also by the Mafia) and to protect taxpayers from rent-seeking of behaviour of pressure groups towards government” (1996, p.2).

They also state that these four objectives are generally agreed upon, but that the constraints, which these countries face, are emphasised differently by different economists. These constraints are summarised as follows:

1) *Uncertainty of outcomes.*

These are present at both aggregate and individual level. There is a problem of having no “blueprint” for a market economy, deriving from theoretical debate within the field of economics and variations in actual practice in the Western world. Furthermore, problems of achieving the overall goal, once defined, are implicit in the transition process. There is neither a comprehensive, nor a consensual theory of transition, and no examples where full transition has been achieved in the real world. This aggregate uncertainty means that there are no clear ideas of costs and which groups have to pay them, and implies that uncertainty is prevalent on an individual level. For individual agents there is the threat of unemployment, unknown in the former planned economies, and policy makers and other economic agents have to make investment decisions taking a high level of uncertainty into

consideration. The problems of speed and sequencing of transition mean that political support is unstable.

2) *Complementarities and interactions between reforms.*

Complementarities appear when two reforms are essential to achieve one or more of the objectives mentioned above. For example, when one attempts to improve allocative efficiency, it is necessary to address price controls as well as questions of ownership. Dewatripont and Roland (1996) mention that contrary to appearance, this does not necessarily mean that 'big bang' programmes are optimal.

3) *Political constraints.*

These are emphasised particularly in the paper, as transition means that there will be winners and losers and thus the governments need to create political constituencies for difficult reforms.

These constraints mean that the speed and sequencing of reform is debated. In particular, the question of whether to free the economy at the earliest possible time and all at once ("big bang" reform) or whether to have a drawn out process (gradual reform), has been debated with strong arguments being presented for both points of view.

The preceding part of Dewatripont and Roland's paper (1996) commences with an analysis of uncertainty of the outcome of partial reform. The key concepts, here, are the presence of an option value for reversal and the introduction of a reform, containing significant information value. These concepts are crucially important in determining the costs of "big bang" versus a gradual approach. They conclude that:

"If early reversal is less costly than full reversal and the first reform is informative, gradualism will be preferable to "big bang" provided learning is fast enough relative to the interim efficiency loss, that is, provided that [the possibility of early reversal] is close enough to one. Otherwise "big bang" will be superior"(p. 5).



This discussion suggests that, in the presence of reversal costs and aggregate uncertainty, a key determinant in the choice of “big bang” versus gradualism is:

“the degree of informativeness about future outcomes” (ibid. p. 5),

rather than the outcome of partial reform.

Given this justification for gradualism, Dewatripont and Roland conclude that in this framework it can be demonstrated that reforms, which are more popular (because of a positive discount rate for future outcomes) and riskier (because the option value for early reversal increases with the variability of the first-period outcome), should be implemented first. This has implications for the timing of transition programmes. If there is an option value attached to early reversal, gradualism will have *ex ante* a higher outcome and thus will be more popular than “big bang” strategies. Gradualism will thus start earlier than “big bang” programmes and will tend to be implemented in countries where the perception of a crisis situation is particularly high. Reforms have to be complementary for gradualism, as otherwise each reform would be judged on its own and be implemented immediately or never. But given this framework, one might even implement a second reform, which might *ex ante* look unattractive, as there is momentum for further reform if the first reform was successful:

“Because of reform complementarity, implementing the second reform is necessary in order to keep the benefit from the first one, and also to avoid the cost of reversing it” (1996, p. 6).

Political constraints, in the context of accession, are discussed in more detail later in this thesis. As Dewatripont and Roland state:

“They are particularly relevant for transition countries in which the move to democracy preceded the move to the market” (p. 7).

To further illustrate, one has to introduce a model with heterogeneous populations to capture the effect of redistribution, which is unavoidable in transition economies. This means that one introduces individual uncertainty, which is caused by aggregate uncertainty. To illustrate, we will use the example of two statistically independent reforms, reform A and reform B. Aggregate uncertainty is represented by both reforms having a positive outcome  $G$  occurring with a probability  $p$  and a negative outcome  $L$  occurring with a probability  $(1-p)$ . Each reform has a reversal cost of  $r/2$ . Here, Dewatripont and Roland remove the effect of lagged learning by using  $\gamma = 1$ , where  $\gamma$  represents a time lag factor. Thus for simplicity, "**immediate learning**" is assumed. The introduction of two different populations to demonstrate redistributive effects follows. *Ex ante* all individuals are assumed to be identical, but the reforms have different effects on both groups. Reform 1 will benefit 2/3 of the population *ex post* by adding an individual benefit of  $g$  for this group on top of the aggregate outcome, while 1/3 of the population have a loss of  $-2g$  for each individual on top of the aggregate outcome. Reform 2, in contrast, will benefit 1/3 of the population *ex post* by yielding a gain of  $2g$ , while the other 1/3 of the population loses  $-g$ , both on top of the aggregate outcome. After both reforms are implemented, the reversal cost becomes  $2 \cdot r/2 = r$ . For the median voter, these assumptions mean that the *ex post* overall distributive effect of both reforms will be neutral. *Ex ante*, each reform is also distributively neutral when taken individually, but each individual reform is not distributively neutral *ex post*. This means that the sequencing of both reforms might crucially affect the political feasibility of reform continuation. The median voter will only go ahead with the second reform if the benefits of the second reform outweigh the costs. A discussion of each case, in turn, now follows.

If reform 1 is implemented first ( $GR_{12}$ ), and the outcome is positive, (i.e.  $G$ ) then the median voter will vote for the second reform, knowing he is among the relative winners of the first reform if:

$$p(2G+g) + (1-p)(G+L+g) \geq -r/2$$



Dewatripont and Roland use the condition that the outcomes of the reform on the L.H.S must outweigh the reversal costs on the R.H.S. by using the symbol  $>$ . This section introduces the symbol  $\geq$  to signify that the median voter will still vote for reform if he is indifferent to continuation or reversal. If reform 1 produces the outcome, L, we will have the continuation condition given by:

$$p(l+G+g) + (1-p)(-r) \geq -r/2$$

The next step involves an examination of the case of reform 2 being introduced first (GR<sub>21</sub>). Initially, the continuation condition is (if the first reform outcome is G):

$$p(2G-g) + (1-p)(g+L-g) \geq -r/2$$

The median voter will continue (if the first reform produces a loss of L) if:

$$p(L+G-g) + (1-p)(-r) \geq -r/2$$

Here, one can already see that continuation is more difficult under GR<sub>21</sub> than under GR<sub>12</sub>:

“In particular, there are parameter values such that continuation is decided under GR<sub>12</sub> if and only if G is realised, while under GR<sub>21</sub>, reversal can never be avoided. In that case GR<sub>12</sub> is optimal and GR<sub>21</sub> is clearly not” (Ibid., 1991, p. 9).

Dewatripont and Roland also note that more irreversibility *ex post* can be a mixed blessing, since it reduces the option value of early reversal, which might be a reason for the political acceptability of GR *ex ante*. For a reformist government this might entail introducing important reforms with a “big bang” when *ex ante* is feasible, by using the window of opportunity present at the beginning of the transition period as this would eliminate the option of early reversal. Here, we can see that these models introduce

“the case for “big bang” (which takes advantage of windows of opportunity to introduce reforms that are costly to reverse) and the case for gradualism (which relaxes *ex ante* political constraints and creates irreversibility through correct sequencing, building constituencies for further reform)” (ibid., 1991, p. 9).

Dewatripont and Roland refer to models concerning the political business cycle and credibility by Persson and Svensson, (1989), "Why a Stubborn Conservative Would Run a Deficit: Policy with Time-inconsistent Preferences" and Alesina and Tabellini, (1995), "A Positive Theory of Fiscal Deficits and Government Debt". These arguments were reinforced in a later paper by Persson and Tabellini (1997) "Political Economics and Macroeconomic Policy". Here, the authors survey the macroeconomic literature on incentive constraints, demonstrating the scope of issues this approach has been applied to. These models focus on the problem of time inconsistency, which is seen as a central problem in government policy. Time inconsistency in the context of transition processes can be described as follows: If a government makes a commitment to implement reform R at the time t, then the market, ideally, should adapt their policies to this reform plan. If the market adapts, the government will be tempted to negate the commitment to reap the benefits of market adaptation without incurring the cost of reform. As the markets anticipate the negation of the commitment, they will not adapt and thus the prior benefits of the reform are lost. This means that the commitment of the government is time inconsistent. An example of this time inconsistency in the context of transition economies might be the stabilisation measures, which could attract large-scale investment. As governments commit themselves to strict monetary policy, they expect investments to come in, which can partially offset the recessionary impact of these measures. But as soon as the investments are in place, the government will have an incentive to relax monetary policy, which means that, if investors have foresight, investments will not come into the country in the first place.

To remove the problem of time inconsistency, there are a variety of possible solutions, which can influence the behaviour of firms and governments. These often concern institution building, which might be part of the objective mentioned before, to build "adequate" institutions for a market economy. It is necessary to briefly explain what we mean by constituency

building. As the part of the economy, which is in private hands, expands during the transition period, more and more people, and lobby groups, are funded by the private sector and thus the number of people supporting reform increases. Other people who are disadvantaged by further reforms can be compensated by transfer systems, which are financed by the gains from previous successful reforms.

In the context of reforms we can consider the possibility of present governments using the window of opportunity to constrain future governments. An obvious example might be privatisation, which would be almost impossible to reverse in future. This could favour “big bang” approaches as long as the possibility of re-election is exogenous. There is, however, an argument which favours gradualism if the possibility of continuing a reform process is endogenous. Here the government could stay in power by introducing popular reforms at first, which could build constituencies for future reforms and future re-election.

One can also use the reform strategies to influence voting behaviours, which are called “divide-and-rule tactics” (Dewatripont and Roland, 1991). They postulate that, given a country with three types of workers, types 0, 1 and 2, working in the sectors 0, 1 and 2 respectively, we can construct the following reform pay-off table:

**Table 1.a.1 Reform Pay-offs without transfers**

	<u>Net gain of type 0</u>	<u>Net gain of type 1</u>	<u>Net gain of type 2</u>
Reform 1	$g_1$	$l_1$	$g_1$
Reform 2	$g_2$	$g_2$	$l_2$
Reform 1 + 2	$g_1 + g_2$	$l_1 + g_2$	$l_2 + g_1$

With  $g_i > 0 > l_i$  for  $i = 1, 2$ .

One has to note, here, that a discount factor would have to be taken into account if the scheme is judged cursive. One has, however, to recognise that a small discount factor makes gradual reform *ex ante* less feasible (as a discount

factor between 0 and 1 means that future gains or losses are comparatively less unimportant).

To have a reform implemented,  $2/3$  of the voters must support the measure. Dewatripont and Roland conclude that if  $l_1 + g_2$  and  $l_2 + g_1$  are negative then “big bang” strategies are not feasible, while gradual strategies can be maintained. This can easily be shown with a numerical example, extending the original analysis.

Assuming  $g_1 = 0.7$ ,  $g_2 = 0.6$ ,  $l_1 = -1$  and  $l_2 = -1$ , we can construct the following pay-off table:

**Table 1.a.2 Reform pay-off without transfers - Numerical example**

	<u>Net gain of type 0</u>	<u>Net gain of type 1</u>	<u>Net gain of type 2</u>
Reform 1	0.7	-1	0.7
Reform 2	0.6	0.6	-1
Reform 1 + 2	1.3	-0.4	-0.3

Here, only a gradual method is possible, as a “big bang strategy” will be opposed by  $2/3$  of the voters. Gradualism is only possible if voters are “myopic” as gradualism means that  $2/3$  of the society will lose out in this scenario in the long term. That is to say that, if big bang is impossible, a gradual approach will only be feasible if the gains from the transition process will accumulate only to a minority of people in the population. This could only be made feasible in the long term by introducing a transfer, as voters have to be kept satisfied over the longer term, which is crucial to maintaining political stability. Assuming that a transfer cost  $t$  of 0.1 exists (which has to be paid at the point in time when the money is taken from the earner) and transfers will be used by the government to make the two losing types indifferent between reform and no reform, and it takes at least two periods to implement the transfer scheme (i.e. it will be taxed in period  $t$  and paid out in period  $t+2$ ) we will get the following pay-off table:

**Table 1.a.3 Reform Pay-offs with transfers - Numerical Example**

	<u>Net gain of type 0</u>	<u>Net gain of type 1</u>	<u>Net gain of type 2</u>
Period 1 (reform 1)	$0.7-a-0.4=0.2$	-1	0.7
Period 2 (reform 2)	$0.6-a-0.3=0.2$	0.6	-1
Period 3 (transfer from period 1)	0	0.2	0.2
Period 4 (transfer from period 2)	0	0.2	0.1
Net gain from the transition process	0.4	0	0

The transfer has been chosen so that in no period more than 1/3 of the people are losing out, thus making it feasible. Other distributions would also be feasible. The point of this example is to show that without redistribution through transfers, this reform plan will always be unfeasible. It is feasible with transfers in the long term, as there are no losers from this process. One has to note that even if everyone is better off in the long term, there is still an argument to make sure that the majority of people have a positive income in each period. This can be explained by assuming that people are concerned with maintaining a minimum standard of living. If the losses in one period push their standard of living below their expected minimum standard, they might vote against reform even if they know that in the long term they would benefit from this process. This is an argument, which is reinforced by uncertainty over future outcomes. It could also explain the initial output fall experienced in transition as the sum of benefits and costs is negative in the first two periods. "Big bang" is not feasible as can be seen in the following table, as long as redistribution takes time to function:

**Table 1.a.4 Reform Pay-off under a ‘big bang’ strategy**

	Net gain of type 0	Net gain of type 1	Net gain of type 2
Period 1 (reform 1 +2)	$1.3-a-0.7=0.5$	-0.4	-0.3
Period 2	0	0	0
Period 3 (transfer from period 1)	0	0.4	0.3
Net gain from the process	0.5	0	0

This shows that even though there is less loss from the transfer ( $a$  instead of  $2a$ ), this scheme is not politically feasible. Thus, one can construct a model in which there is credibility in a transfer scheme, which will provide gains to all types from the transition process. How these transfers are implemented is a matter of political choice, as one could also envisage a scheme by which only one of the loser groups is compensated and, correspondingly, there is a long-term majority of  $2/3$  instead of the whole population supporting the process. “Big bang” strategies are not feasible because of the time lag in the transfer process. Even though the time lag is an artificial construction, it represents a real problem of the transition economies. This problem is the ineffectual tax collection mechanism as well as ineffectual rules for transfers. Furthermore, at the moment it is almost impossible to collect any taxes because of the recessionary effect on the economies, which are hit by recent falls in output and large unemployment. This makes it almost impossible to compensate disadvantaged groups in the current period.

Therefore, if there is a necessity for one reform to be implemented before another can take place, we might have a situation in which, in the short and in the long term, the only possible path to implement the reforms is a gradual one. This could be the case if, for example, prices have to be liberated and firms have to be privatised before the effect on the allocation of resources is noticeable and increases in employment start to take place. This could

create losses for a large number of people and, in the short term, might not be politically feasible. If privatisation occurs first and those benefits are distributed so that the disadvantaged groups from price liberalisation will be compensated, then this might enable the price liberalisation, which together will increase allocative efficiency in the long term.

Dewatripont and Roland, (1996) also discuss transfer schemes. However, they focus on the effect of gradualism on the size of the transfers, not the feasibility aspect of transfers. They firstly concentrate on asymmetric information in the context of transfers and conclude that under these circumstances, gradualism dominates a “big bang” strategy and is the time consistent optimum whenever budget considerations are of importance. This reinforces the conclusions reached previously within this thesis.

Finally, they discuss the effect of possible secession on transfer schemes. Here, secession, or the threat of secession alters the majority of structures within a country. They conclude that:

“The possibility of secession allows here a reduction in the amounts of transfers paid to the losers from reform since it changes the *status quo* in case of rejection of reform proposal” (Dewatripont and Roland, 1996, p. 14).

Thus, Dewatripont and Roland, and the extensions in this section analysis, present a theoretical argument that demonstrates that gradualism under uncertainty and political constraints, can be the only feasible path to reform. The importance of these arguments is reinforced in other papers. Roland (1994) in “The role of political constraints in transition strategies” emphasises the advantage of a “big bang” strategy in terms of constraining a successor government, but recognises that one needs windows of opportunity to make “big bang” feasible. He still maintains that gradual strategies create irreversibility by creating constituencies.

He summarises seven limitations of a gradual approach:



- 1) The option value of early reversal has to be positive.
- 2) Gradualism may be ineffective if a window of opportunity exists and a 'big bang' package is feasible.
- 3) Gradualism may be ineffective if there is no learning process, which creates benefits from the first reform.
- 4) The use of the above described "divide-and-rule tactics" might not be possible under all democratic frameworks.
- 5) The option value of reversal deters investment.
- 6) Without a critical mass of reforms, there might be a problem of signalling the future political feasibility of the economic reform programme to economic agents.
- 7) The wrong sequencing of reforms might be more damaging than a "big bang" approach.

He shows that in many Visegrad countries gradual reforms have been implemented and concludes that the 'big bang' approach emphasises how speed in reforms may constrain a successor government, whereas the gradualist approach tries to design the sequencing of reforms to build, at each stage of transition, constituencies for further reform. These issues are crucially important when these models are applied to the debate on the preparation of Eastern Europe for EU membership.

The above illustrates that analysis of the transition process by using macro-economic models has contributed important aspects to the discussion of transition. In particular, the models have demonstrated that under certain circumstances a gradual approach can be optimal. The 'big bang' approach, so widely advocated in the immediate aftermath of the revolutions, can be the more costly approach. Furthermore, the models have shown the importance



of constraints in the accession process. The constraints, which can alter the reform path of a country, are particularly important in the context of constituency building. Political constraints, related to the distributive effects of reforms and voting patterns, can cause the abandonment of reforms if sequencing is not taken into account. The problems of sequencing are reinforced by complementarities of reforms, which have to be taken into account to determine the correct transition strategy. Transfers are crucially important in enabling certain reform strategies and need to be modelled explicitly.

Furthermore, time inconsistency plays an important role in the transition process. As governments have no mechanism to commit credibly to a reform path, the incentive to deviate from a pre-announced strategy can be overriding. As a consequence the announcements of government strategy are disbelieved, entailing a more costly reform path, indicating that Time Inconsistency is present.

The final important constraint is uncertainty, which is pervasive in the transition process. Uncertainties generally increase the cost of transition and can alter the optimal path to the creation of a functioning market economy.

These models are designed to model the transition, not the accession, process. Even though it is necessary to take into account the constraints raised by the macro-economic models of the accession process, the models need to be adapted to take into account the specific circumstances, of the relationship with the European Union. In addition, any model of the accession process must account for the historical starting point and the institutional and cultural background of the applicant countries. The following section reviews the literature, which examines the relationship with the European Union, while the following chapters determine, respectively, the historical starting point of the applicant countries and their current position in the accession process.

## Chapter 1: Literature Review

### b) Literature on the Accession Process

The models described in the previous section relate to the transition process, not to the relationship of the CEECs with the European Union. In this field, modelling is rare, if not almost non-existent. This thesis attempts to address this imbalance. Yet there exists a vast amount of literature on the accession process, mainly from a political or international relations perspective. Historical accounts of Eastern Europe and the accession process are also numerous. A notable overview of European history is Norman Davies' "Europe". The book covers European history comprehensively but due to its compact nature cannot give a detailed account of all events. For a factual examination of the transition period, the compilation "Eastern Europe and the Commonwealth of Independent States" published by Europa Publications covers the details of the transition period in great accuracy. The compilation is written by a number of authors, examining each CEEC's history and economy, as well as some essays on overarching developments. This can be usefully contrasted to the developments in the EU, summarised in the book "Western Europe 2000" also by Europa Publications. However, only a few authors have examined the accession process from an economic perspective.

One of the most notable books on the subject is Richard Baldwin's "Towards an integrated Europe", (1992). He states that it is unlikely that EU membership, for the applicant countries, will take place for decades, given the constraints faced by the EU. The problems he mentions include the reforms of the Common Agricultural Policy (CAP) and the European Structural Funds (ESFs) and the associated EU budget reforms. Furthermore, he discusses the necessary institutional reforms, as well as migration and security issues.

He also demonstrates that the CEECs face major challenges in institutional reforms, as well as facing an ever-increasing EU integration process. He warns that excluding the CEECs from parts of the European integration could

lead to a perception of second class membership. Baldwin advocates the creation of an intermediate, all inclusive agreement for the CEECs, in preparation for membership, an argument which is taken up in later literature (see, for example, Dangerfield, 2000).

Many of Baldwin's issues were further investigated in his conference paper, "Concepts and Speed of Eastern Enlargement", (1996). He reiterates the problems of Eastern enlargement and parallels the accession process with an engagement, where the wedding date has not been set and the bride price could pose problems. The issues associated with the EFTA enlargement are examined in Baldwin et. al. (1995) "Expanding Membership of the European Union", which explores some of these issues in the context of Europe's latest accession<sup>3</sup>.

A further book examining the scope of the reforms the transition countries faced is "The New Eastern Europe: Western Responses" (Rollo, 1990). The book demonstrates the multitude of actors involved in the process and the possible policies they can pursue (Rollo, Table 6.1). Rollo expresses doubt about the prospects of quick membership:

"To try to absorb the East-Central Europeans (and the Balkans in due course), with their economic structures in transition and their lower standard of living, is difficult to contemplate. The prospect of managing a community of up to 25 states, all at different levels of economic development, is daunting" (ibid., p. 114).

This doubt has been proven to be justified, but now the community is facing an enlarged group of applicants with the possibility of more applications to come<sup>4</sup>.

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<sup>3</sup> The accession of Austria, Finland and Sweden in 1995.

<sup>4</sup> Currently there are 15 memberstates and 13 countries have applied to join. Further possible applicants include the EFTA countries (Iceland, Liechtenstein, Norway and Switzerland), as well as further Balkan states (Albania, Bosnia, Croatia, Macedonia (FYROM), possibly Montenegro and, in

Susan Nello's, "The New Europe", (1991) focuses on the economic relationship between East and West. It gives a good overview of the economic relationships during the Cold War and shows how trade could develop in different sectors. However, the book goes further and considers the reforms necessary in the East and what the West could do to aid this transition. The book also discusses possible future developments and warns that reforms need to take place on both sides:

"It remains to be seen whether the European integration process can maintain the momentum required for such far-reaching changes" (p. 265).

Later discussions address specifically the accession process and associated constraints. "Back to Europe: Central and Eastern Europe" (Henderson (ed.), 1999) reviews many of the issues relevant to the accession process. The book addresses three major issues of the accession process: security, structural EU reforms and political developments in the CEECs. Even though some positive aspects are analysed, the book shows the scope of problems remaining in the accession process. Another book addressing the specific question of accession is "The Enlargement of the European Union" (Avery and Cameron, 1998). The authors detail, specifically, enlargement as a process, which needs to be addressed in its own right. They catalogue the developments of recent years, including the developments since the official response, to the applicants of the CEECs, of the Commission, Agenda 2000. They warn that the accession process will be long and difficult, yet they emphasise that this process also offers opportunities to improve the fundamental structure of Eastern Europe and, thus, to increase living standards throughout the continent.

The problems of uncertainty of timing are reflected in many papers. For example, Galinos ("Central Europe and the EU: Prospects of Closer Integration", 1994) considers that even though the EU acknowledged Eastern

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the longer term, Yugoslavia) and even the Eastern states of Byelorussia, Moldavia, the Ukraine and maybe even Russia itself. This could mean a long-term membership of the EU of around 40 states.

European aspirations, rapid accession is unlikely and the hopes of the CEECs might well prove to be over-optimistic. Jan B. de Weydenthal, (1994), acknowledges that there are many problems in the accession process, yet re-emphasises that political considerations might well overrule economic concerns.

Dobroczynski (1994) emphasises the serious constraints still impeding accession ("Eastern Chances for creating Europe's Unified Economy"). He reinforces the necessity for socio-economic forces and societies to participate in this process:

"Positive mobilization of society will to a large extent depend on how the new regimes cope with the twin challenges of economic reconstruction and harmonisation of the interests and attitudes of different social groups" (Ibid. p. 12).

This process does, however, depend on the CEECs undertaking fundamental reform of civic society and shouldering the corresponding costs:

"If Eastern Europe wants to be admitted to the European Economic Community on an association and eventually full membership basis, it will have to carry out quickly a vast number of reforms - and of a far more serious nature than at first glance might appear" (Ibid. p. 19).

The scope of necessary transitions is also discussed in Paul Hare (1996), "How far is Eastern Europe from Brussels", with a particular view to those reforms necessary to achieve compatibility with the EU's common market. He regards the process as resulting in a segmented Europe:

"the G1 countries [Czech Republic, Hungary, Poland and Slovenia] will become full members of the EU within a fairly short time, say within five years, that the G2 countries [Baltic States] may enter in the subsequent five years (conceivably also including Slovakia from G3), with the remaining countries either never entering the EU or joining much later" (p. 9).

Even this pessimistic timetable is in danger of slipping behind, with the G1 countries being unlikely to join before 2003-2005.

A further attempt to examine the lessons from the accession process is by Hans-Werner Sinn (1999) in "EU Enlargement, Migration and Lessons from German Unification". He examines German Unification, which provides the first example of a transition country joining the EU. He uses a formal model to predict that there will be migration from the new EU members to the existing ones, which is later reversed. He asserts that this migration is efficient and should not be constrained. Yet he does not address the problem of political resistance to large-scale inward migration, already evident in many EU countries.

The inter-disciplinary nature of the process makes it impossible to catalogue anything resembling the complete literature in the field. The literature examined in this chapter provides only a broad overview of the background to the accession process. Further literature will be examined through Evidence of Constraints in Chapter 5. The review in this chapter has shown that there is a need to combine the methodology employed by transition economists with the particular features of the accession process. To understand the accession process it is necessary to establish the background of the applicant countries and the starting point of the accession process. The following chapter examines the historical development of the applicant countries, while Chapter 3 examines the current situation and the applicants' relationship with the European Union.



## Chapter 2: Historical Development

### a) Issue Definition and Country Classification

The accession process cannot be understood without taking into account the historical trends in the applicant countries. Despite the many changes these countries have gone through, some of the issues have remained throughout history and need to be understood in context. Alice Teichova notes about the transition period:

“The same aspects have once more emerged as the central problems of the Eastern European economies at the present time. They are concerned, in the first place, with land reforms, in the second place, with lack of capital, and, in the third place, with market problems” (1997, p. 7).

The desire to become members of the EU is rooted deeply in the insecurity and conflict of Europe over the last centuries. Daniel Daianu notes:

“One can [also] detect another meaning which crosses ideological borders and has defined the evolution of these societies throughout this century, the quest of catching up with the West, an idea which obsessed national politicians in the interwar period, communist leaderships bent on proving the alleged superiority of their system, and which, today, is reflected in the ardent desire to join the European Union” (in Teichova, 1996, p. 83).

The fear of Soviet domination can only be understood in the context of the Cold War and the subsequent revolutions. Furthermore, the economic starting point of the accession process is determined by policies pursued by the communist regimes, which crucially influence the scope of, and the ability to deal with, the political and economic reforms which are necessary to create a functioning market economy. The tendency of state intervention and a lack of democratic legacy are also crucially important to understand the communist period. Teichova notes about the CEECS:

“They had a long tradition of massive state intervention in their economies which continued throughout all political and social changes practically until the present time – except for interwar Czechoslovakia. Although even in this case government controls were tighter than in similar democratic states with a capitalist economy. Most importantly, when taking into account historical



realities, none of the Central and Southeast European states – again except for interwar Czechoslovakia – have experienced a democratic system with a parliamentary form of government, i.e. a pluralistic political system which is held to be compatible with a functioning market economy” (1997, p. 5).

The final section of this chapter examines the revolutions in CEE, demonstrating the speed and scope of changes people had to accommodate at the beginning of the transition period. Many of the events are, by necessity, examined in extensive detail, especially in demonstrating the turning points of the country’s history. It is impossible to overstate the importance of historical developments for the CEECs. The whole transition and accession process is a continuation of the much longer historical trends prevalent in Europe. A more detailed historical examination is beyond the scope of this thesis but for a comprehensive account of Europe’s history see Norman Davies, “Europe - A History”, (1997).

To appreciate the development of the CEECs, it is necessary to analyse their geographical situation, their history, their current economic situation and their relationship with the European Union. In this chapter the historical development of the applicant countries is examined up to and including the revolutions, which shook the continent at the end of the 1980s and the beginning of the 1990s. The chapter examines the economic geography of the applicant countries and shows that the starting point for different groups of countries is quite different, in particular when regarding proximity to the European Union. Furthermore, their initial resource endowment and the structure of each economy varies widely. The chapter continues by examining the cultural and political institutional background of these countries. It shows that despite the differences, there is a degree of shared history. In particular, the experiences within the pre First World War balance of power and the descent into dictatorship in the post war period and the Second World War, demonstrate a certain similarity in institutional history. Additionally, the shared experiences of the Cold War and the revolutions are similar in all the applicant countries. The chapter, thus, illustrates the distinctive differences between the applicant countries, which makes their starting points of the

accession process distinctly different, whilst demonstrating that there are a number of important similarities. These are especially noticeable when the countries are divided into groups according to their shared experiences.

For the analysis in this chapter the ten applicant countries<sup>5</sup> have been divided into four groups, which, to a certain degree, share a common history. In particular, they have been divided into the following groups<sup>6</sup>:

- Group 1: The Visegrad<sup>7</sup> countries {the Czech Republic (Prague), Hungary (Budapest), Poland (Warsaw) and Slovakia (Bratislava<sup>8</sup>)<sup>9</sup>}.
- Group 2: Slovenia (Ljubljana<sup>10</sup>)<sup>11</sup> {former Yugoslavia}.
- Group 3: The Baltic States {Estonia (Tallinn), Latvia (Riga) and Lithuania (Vilnius)}.
- Group 4: South-Eastern Europe {Bulgaria (Sofia) and Romania (Bucharest)}.

Each of these groups has its own unique features, which can be seen clearly when examining their borders and geographical position. The examination of the applicant countries' geographical situation is important to set them in the context of the EU to the West and Russia to the East. Furthermore, the geographical position of the applicant countries is important in their relation with each other, which is partially determined by the many changes of borders detailed later in this chapter. The proximity, or distance, from the EU will also influence crucially the accession process. The EU is unlikely to admit a country, which has no direct borders or sea links to the EU. Furthermore, the neighbouring EU countries will also have the most

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<sup>5</sup> Cyprus, Malta and Turkey, even though they have applied to join the EU, are treated separately in the accession process.

<sup>6</sup> The Capital cities of each country are shown in brackets.

<sup>7</sup> Named after the Central European Free Trade Agreement which was founded by a common declaration of the heads of state of Czechoslovakia, Hungary and Poland at Visegrád /Hungary on the 15.2.1991 (Der Fischer Weltalmanach '95, p. 773-774).

<sup>8</sup> Or Preßburg, as it was known within the Habsburg Empire.

<sup>9</sup> Slovakia is included here due to the shared history with the Czech Republic within Czechoslovakia. The separate development of Slovakia after the dissolution of Czechoslovakia will be discussed in detail later.

<sup>10</sup> Or Laibach, as it was known within the Habsburg Empire.

<sup>11</sup> Slovenia is not included in any of the other groups, because historically the history of Yugoslavia diverges from the other groups.

interest in accession of these countries, acting as a possible advocate for membership within the EU.

Group 1 borders on Germany and Austria to the West, while sharing a border with Russia<sup>12</sup>, Byelorussia and the Ukraine to the East. Hungary shares borders in the South with Slovenia, Croatia and Serbia, and also with Romania to the East. Poland also shares a border with Lithuania and it is the only country, in Group 4, with access to the Baltic Sea. While the other countries are landlocked, they share some of the most important European rivers between them, most notably the Danube (Donau), the Vistula (Weichsel), the Odra (Oder) and the Vltava (Elbe).

Group 2 borders Austria and Italy to the West and also shares borders with Hungary and Croatia. Slovenia is a mountainous country and it is the only applicant country with access to the Adriatic Sea.

Group 3 is characterised by Russia and Byelorussia to the East and the Baltic Sea to the West. Despite close connections to Scandinavia, they share no direct land border. Lithuania's only frontier with Russia is to the West<sup>13</sup> and it has borders with Byelorussia to the East and Poland to the South.

Finally, Group 4 borders on Yugoslavia to the West<sup>14</sup> and the Black Sea to the East. The internal shared border for the most part is the Danube and Bulgaria borders Macedonia<sup>15</sup>, Greece and Turkey to the South. Romania borders the Ukraine and Moldavia to the East and shares a border with Hungary to the West.

All of the groups share a border with a present EU member state and each group has access to a major waterway. Romania would, however, need another applicant<sup>16</sup> to gain membership before sharing a direct border with the EU. Lithuania would need Poland to join, to share a land border, while

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<sup>12</sup> The city of Kaliningrad, East Prussia (formerly Königsberg) has been under the control of Russia since the Second World War.

<sup>13</sup> See footnote above

<sup>14</sup> In particular they border the Yugoslav Republic of Serbia, which together with Montenegro and the former autonomous region of Kosovo (now part of Serbia) make up Yugoslavia.

<sup>15</sup> FYROM, the former Yugoslav Republic of Macedonia.

<sup>16</sup> Hungary or Bulgaria.

Latvia needs Lithuania to join to share a border on land and Estonia would need Latvia, Lithuania and Poland to join<sup>17</sup>.

There are also substantial differences in the resource endowment these countries have within their borders. These have created some specialisation in industry as well as different methods of energy generation. The COMECON, the Soviet-dominated equivalent of the EU, enforced further specialisation.

Group 1 has substantial coal production<sup>18</sup> and usage, as well as using nuclear energy to generate electricity in most countries<sup>19</sup>. Oil and gas are mainly imported from Russia through an existing network of pipelines. There is some iron and steel production, as well as manufacturing industry, especially for mechanical engineering, car manufacturing and shipbuilding<sup>20</sup>. A substantial, but declining, percentage of the workforce is engaged in agricultural activity.

Group 2 is still economically characterised by the legacy of Yugoslavia. Slovenia has a nuclear power station which it shares with Croatia<sup>21</sup> and it produces and uses lignite for energy production. There is some manufacturing related to mechanical engineering and there is also some chemical production. There is still a substantial workforce in agriculture and Slovenia has a growing tourism sector.

The Baltic States have a large service sector, which is partially explained by financial activity. These countries also produce a large number of products in the primary sector and still have a substantial part of the workforce employed in agriculture. There are few industries and these are engaged mainly in chemicals and textiles. A relatively large share of trade is

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<sup>17</sup> This is however not a major obstacle to integration as the Baltic Sea connects both Reval and Riga relatively directly with Helsinki and Stockholm.

<sup>18</sup> Hard Coal as well as lignite, which is mainly used as an energy provider, as it is cheaper but it is also more environmentally damaging.

<sup>19</sup> At Pak in Hungary, at Dukovny and Temelin in the Czech Republic and at Bohunice and the planned power station at Mochovce, in Slovakia. Poland does not have a nuclear power programme.

<sup>20</sup> Shipbuilding is taking place in Poland, even though this industry seems to be in substantial decline.

<sup>21</sup> At Krsko in Slovenia.

conducted with Russia<sup>22</sup>, which also supplies most of the energy to these countries. In Group 3 only Lithuania has a nuclear plant<sup>23</sup>, which is due to shut down as one of the conditions of accession.

The countries in Group 4 have a more diversified economy, albeit in a very uncompetitive state. These countries rely mainly on primary products for exports, but they also produce iron, steel, ships, chemicals, and products associated with mechanical engineering. Bulgaria also has a large tobacco industry and some tourism along the Black Sea. Romania produces oil and gas and Group 4 also has nuclear energy for electricity production<sup>24</sup>. There is an especially large part of the workforce engaged in agriculture in Romania<sup>25</sup> but Bulgaria also has a large percentage of the workforce in this sector.

It is clear that the applicant countries have some geographical similarities, but their differences in location create different foreign and economic policy pre-occupations, as well as defining the main contact partners within the EU for each of these groups. It is clear that Group 1 will gravitate naturally towards Germany and Austria, while Group 2 is concerned with Austria and Italy. Group 3 has its closest links with the Scandinavian countries, even though they share no direct land border. Group 4 has some contacts with Greece, but is generally the most remote from the European Union.

It is necessary to emphasise that the inter-relations between the applicant countries are crucially important. Due to their history, in particular the developments after the First World War and the Second World War, they all had or have some border disputes with each other or other neighbouring countries. These will be examined in more detail later when the recent history of these countries is analysed and they will also feature in the relationship of

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<sup>22</sup> Imports: Estonia 46%; Latvia 30% (reflecting the lower requirement of energy imports); Lithuania 41%. Exports: Estonia 25%; Latvia 29%; Lithuania 24%. (1993; Source: Harenberg Länderlexikon, p. 265).

<sup>23</sup> At Ignalina, which is due to be shut down even though the country heavily depends on this energy for the time being.

<sup>24</sup> At Kozludy in Bulgaria and Cernavoda in Romania.

<sup>25</sup> 20.3% in 1991 (Source: Harenberg Länderlexikon, p. 347)

these countries with the Western states. The disputes over land confiscated after the Second World War have already lead to disputes of applicants with EU member states. Furthermore, border disputes, and the associated ethnic minorities within the applicants' territory, can result in conflict, as seen in the territory of former Yugoslavia.

The mix of industry in these countries, as well as their large agricultural sector will be re-examined when the current position is analysed, in Chapter 3. It is, however, clear that each of these countries still faces some substantial problems to be able to fulfil the obligations of membership, as their industries are neither highly diversified, nor competitive in most cases.

The history of these countries is inextricably bound to their present state and it requires further examination. The policies these countries have pursued and their geographical and economic situation can only be understood when they are set in the context of their history. The strength of aspirations for membership have to be analysed by taking the primary motive of their application into account - to ground their society firmly in the Western European system of security and economic co-operation. For this part of the thesis, the groupings introduced earlier in this chapter will be used. They are useful in providing a categorisation of these countries, in terms of their shared experiences. It is, however, necessary to emphasise that no CEEC is strictly comparable to another and thus, the analysis will return to individual countries frequently.

The history of all of these countries will be discussed until the revolutions at the end of the 1980s and the beginning of the 1990s. The reforms and transformation of each country resulted in a chain reaction, which finally lead to the disintegration of the Soviet Union and the communist bloc. The history of the CEECs is interwoven in recent developments and will, thus, be examined as a coherent whole in the next chapter of this thesis. This part of the thesis will analyse the history of the CEECs from their beginning, until the late 20<sup>th</sup> century. The analysis will



mainly focus on the 20th century itself, as this period is most relevant to the accession process. Nevertheless, long-term trends will also be discussed.

In the first part of this section the ancient history of these countries is discussed, culminating in the First World War. The second part will discuss the inter-war period and their subsequent involvement in the Second World War. Subsequently in this section, the period after the Second World War is analysed, which is characterised by Soviet dominance and the Cold War. The next part of the chapter will then discuss the revolutions, which have taken place in the last part of this century.



## **Chapter 2: Historical Development**

### **b) Early History and First World War**

The historical detail is examined in this thesis for a number of reasons. Without understanding the historical developments and historical trends, the present position of the applicant countries cannot be determined or appreciated. Furthermore, the historical development shows how these countries have come into existence and it illustrates the changes in boundaries and attitudes, which have occurred in their history. This sense of historical identity, partially driving the revolutions of the 1980s and the 1990s, defines the applicants' countries wish to become part of the European integration process. The violent history of this century has also caused a strong desire for stability and security in CEE, which is seen as being deliverable by membership of the EU. Finally the transition and the accession process are part of a much longer process of historical developments and can be seen as one episode of a long-term search for identity in CEE. As historical identity can crucially influence the political process, in particular where no previous democratic history can shape new beliefs, it is essential to determine the applicants' historical development.

Group 1 - the Czech Republic, Hungary, Poland and Slovakia - contains countries, which derive their present territory predominantly from the changes after World War I and World War II. They do, however, have a much longer history, albeit not necessarily as independent countries at all times. Their histories have been characterised by changing alliances and territories, resulting from their central position in the heart of Europe. Black summarises their position in relation to Western Europe by observing:

“While the western European Powers founded great trading and colonial empires in the early modern period, the states of central and eastern Europe were involved in a bitter fight for survival”(1990, p. 282).

The struggle between the European states and the powers to the east has been a major theme in the history of the last millennium. This has led to numerous wars being fought in the territory these countries occupy and the wish for integration can be extrapolated from these conflicts, as a method to prevent further conflict.

Poland can look back on a long history, which has often resulted in repartitions of the Polish State. The Polish people have been known to settle in the general area since the 11th century. They are predominantly Slavic and most of the population is Catholic<sup>26</sup>, but there were always areas settled by different ethnic groups and most notably ethnic Germans. They were united in a kingdom with Lithuania in 1569<sup>27</sup>; this kingdom surviving until the late 18th century. The precarious situation of Poland did however involve a balancing act between the major European powers. With the Habsburg Austrian-Hungarian Empire to the South, the Tsarist Russia to the East and the newly emerging Prussia to the West, this balancing act could not be maintained indefinitely. Poland was annexed at different times by different powers according to the state of the conflict between them. It changed hands in 1772, 1793 and 1795. Poland, together with some Swedish Baltic possessions, was the main issue in the Great Northern War between Russia and Sweden and their various allies. Russia managed to gain territory in the 18th century and:

“By mid-century Russian hegemony in Eastern Europe was well established” (Black 1990, p. 287).

Poland had already been forced to cede most Eastern provinces to Russia and the remaining kingdom was only very limited in territory. The Congress of Vienna in 1815 legitimised this kingdom:

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<sup>26</sup> At present roughly 95% of Poles see themselves as Catholic.

<sup>27</sup> There had been a personal union of the Jagiellonian kings since 1385 but in 1569 the Polish-Lithuanian Rzeczpospolita (republic) was formed.

"A so-called 'Congress Kingdom' was set up, nominally independent but its monarchy hereditarily vested in the Romanov dynasty. ... . Most Poles continued to live under Prussian rule in Poznan ..., under the Austrian rule in Galicia, ..., or under Russian rule in the vast expanses of Lithuania, White Russia, and the Ukraine." (Gildea, 1987, p. 59)

Finally, in 1864, it formally became a part of the Russian Empire where it remained until the First World War. The German invasion of Tsarist Russia and the subsequent defeat of the Russian Empire<sup>28</sup>, which was sealed by the treaty of Brest-Litovsk in 1918, meant that large parts of Polish territory were ceded to Germany until the end of the war. The Russian Empire disintegrated into civil war, which ended in Bolshevik victory, but it was too weak to influence events in Eastern Europe, which were seen as its decisive area of interest. After the First World War, Poland became one of the buffer states between the newly formed Soviet Union and Germany. This inter-war period is the one period in which Poland has enjoyed a large degree of independence in recent history. This will be examined in greater detail later.

Both Hungary and what was to become Czechoslovakia were part of the Habsburg Empire for centuries. The Habsburg Empire was an empire of diverse nationalities<sup>29</sup> and diverse economic developments and thus:

"both historical and economic factors combined to make the internal unity of the Austro-Hungarian Monarchy problematic." (Cipolla, 1973, p. 238)

Moreover, the territories which became Czechoslovakia and Hungary had very different roles in the governing of the empire. While Hungary was one of the kingdoms, which made up the core of the Austro-Hungarian Empire, Bohemia, Moravia<sup>30</sup> and Slovakia were mere provinces of the empire. Hungary was thus a much more powerful entity and the treatment of both of these states was recognisably different after the First World War. Both

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<sup>28</sup> The Tsarist empire had effectively ceased to exist at this point in time as the internal developments within Russia were gathering momentum after the February and October Revolutions in 1917.

<sup>29</sup> At least eleven major nationalities including Germans, Magyars, Czechs, Slovaks, Romanians, Poles and Slovenes (Cipolla, 1973, map p. 234 & 235).



countries had been part of the coalition of Austria-Hungary and Germany. Having lost the war, Hungary was cut back in size, leaving large Hungarian minorities in many parts of Eastern Europe, while Czechoslovakia, like Poland, was created as a buffer state between Germany and the Soviet Union.

Hungary looks back on a long history, which is still seen with pride by many Hungarians. Settled by Magyar tribes it became an independent kingdom in the 11th century under King Stephen I. The Hungarians were mainly Catholic but the reformation saw a strong Calvinist minority developing<sup>31</sup>. It saw itself as bulwark against the Ottoman Empire and was engaged in many battles with the Turkish forces. It was, however, conquered in 1526 and remained occupied until the 17th century. When it became free of Turkish rule, it became one of the component kingdoms of the Habsburg Empire and remained in the dual monarchy until the First World War. It was:

“a kingdom that was hereditary in the Habsburg line and that included Slovakia in modern Czechoslovakia and Croatia, Dalmatia and Savonia in modern Yugoslavia”(Black ,1990, p. 361).

Hungary had always taken the second role in the empire and it became increasingly resentful, not only against the Austrians but also against other nationalities within the Empire:

“Their nationalism was not cosmopolitan, like that of the Poles, but extremely chauvinistic. The Hungarian ‘nation’ was composed of Magyars alone, and made no concessions to Slovaks, Croats, Serbs, or Romanians.”(Gildea 1987, p. 73)

After the Great War, Hungary became an independent republic albeit with a drastically reduced territory and population. The instability created a communist regime under Béla Kun in 1919, but in 1920 the monarchy was restored. The reduced importance of Hungary, as well as the treatment of Hungarian minorities in other Eastern European countries, made the inter-

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<sup>30</sup> The component areas of the Czech Republic.

war period potentially unstable, which finally lead to the Hungarian alliance with Nazi Germany, a process which will be analysed in more detail later.

Czechoslovakia, on the other hand, only became an independent country in the inter-war period. Even though there had been a Moravian kingdom in the 9th century and an independent Bohemian-Moravian kingdom which reached its peak in the 14th century, the kingdom became incorporated into the Austrian empire in the 16th century. Bohemia, Moravia and Slovakia were provinces within the Habsburg state. The Czech part of the Austrian Empire was a stable part of the monarchy:

“The Bohemian nobility was German-speaking, imposed on the province from the seventeenth century, and loyal to the dynasty”(Gildea, 1987, p. 73).

The Slovak people were less integrated and there was some movement for independence. But until the First World War this did not become a reality, partially because Slovak independence had no precedent:

“Clearly the previous existence of a separate state strengthened claims for national autonomy or even independence. The Slovaks could prove nothing here ... ”(Gildea, 1987, p. 74)

Most Czechs and Slovaks are Catholic, but there are also substantial minorities within this geographical area. This resulted mainly from the strategic creation of the Czechoslovakian State. Czechoslovakia was created by the break-up of the Austrian-Hungarian Empire and served as a buffer in the centre of Europe. The arbitrary connection of the Czechs and the Slovaks did lead to the unravelling of the Czechoslovakian State 75 years later<sup>32</sup> but there were more immediate concerns for the young republic. The deliberate inclusion of a mountain range (from the Erzgebirge<sup>33</sup> in the North to the Bohemian Forest in the West) as a geographical barrier to Germany, meant

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<sup>31</sup> Present day religious affiliations are roughly 2/3 Roman Catholic and 1/5 Calvinist.

<sup>32</sup> The Federal Republic of Czechoslovakia lasted from 1919-1993 with the exception of the Second World War.

<sup>33</sup> This is the German name which literally means the Ore mountains.

that a large number of ethnic Germans, the so-called Sudetendeutsche, lived in the territory of Czechoslovakia. This created a potential source of conflict, which resulted in the Czech army being built up in the inter-war period, as well as numerous alliances with Western powers. Thus the inter-war period was characterised by uncertainty and potential conflict, later detailed.

Slovenia in Group 2 has had a similar history to Czechoslovakia until the First World War. Slovenia was settled by Slavic people who became known as Slovenes and became, subsequently, a part of the Habsburg Empire. Being the furthest Western of the Balkan states it was a stable part of the empire for most of its modern history. During the Napoleonic occupation, the Illyrian provinces in the area of Slovenia and Croatia were established, creating a movement for independence within these territories. But, with the Congress of Vienna, these kingdoms were dissolved and the Slovenes were once more

“sliced up between the Austrian provinces of Carniola, Carinthia, and Styria”(Gildea, 1987, p. 74).

But even though the Vienna Congress restored them to the Habsburg Empire they achieved a high degree of independence within it.

The Balkan region has been characterised by instability for most of modern history. The annexation of Bosnia by the Habsburg Empire in 1908 and the subsequent unrest provided the spark, which set the First World War in motion. With the break-up of the Austrian-Hungarian Empire the area became unified in a single monarchy, which was named the Kingdom of Serbs, Croats and Slovenes until it was renamed the Kingdom of Yugoslavia in 1929. In the inter-war period, the differences between the component parts of the kingdom became clear and this period was characterised by rising hostilities and instability, creating a legacy, which can still be observed today. Thus, Slovenia was unable to escape the Balkan conflict, detailed later.

The history of interchanging independence and occupation can also be observed when we analyse the countries in Group 3. The Baltic States,



Estonia, Latvia and Lithuania, were occupied by Tsarist Russia. Lithuania was in a joint kingdom with Poland as mentioned before, while Estonia and Latvia formed part of this territory after having been independent principalities<sup>34</sup>. Sweden and Russia, in the Great Northern War, contested these territories. The Great Northern War was effectively decided when Peter the Great of Russia defeated Charles XII of Sweden at Poltava in the Ukraine:

“Peter’s crushing defeat of Charles at Poltova in the Ukraine in 1709 solved both the Polish question and that of the Baltic provinces. ... . In the same year (1710) Russian troops overran Sweden’s Eastern Baltic provinces, bar Finland, Russia’s possession of which was not challenged seriously until the time of Napoleon”(Black, 1990, p. 285).

Thus, Lithuania became part of Russia after Poland was occupied at the end of the 18th century<sup>35</sup> while Estonia and Latvia had already been ceded to Russia in 1721. They remained part of Tsarist Russia until the First World War, even though various attempted revolutions, especially in Lithuania, showed their resistance to "russification"<sup>36</sup>.

The Napoleonic era challenged Russian possession, but after Napoleon’s defeat, the Congress of Vienna recognised Russian hegemony in most of Eastern Europe. The First World War brought military defeats for Russia and ultimately resulted in the Bolshevik revolution. After Germany was defeated on the Western front, the end of the First World War brought the Baltic states their independence in 1918. This was, however, contested by the newly emerging Soviet Union and their independence was short-lived. Yet in the inter-war period these countries enjoyed an unprecedented period of independence, later examined.

The countries in group 4, Romania and Bulgaria, also have an ancient history to look back on, even though they have enjoyed far shorter periods of nationhood than most countries in the modern era. They have been at the

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<sup>34</sup> Latvia was known as Livonia in the early Middle Ages.

<sup>35</sup> Russia annexed most of Lithuania in the period 1773-1795.



junction of the Ottoman Empire and the European states and their identity largely derives from this situation. Both countries have substantial minorities both in terms of ethnic groups and religious groups. Bulgaria still has a substantial Muslim minority even though the main religion is Bulgarian orthodox<sup>37</sup>, as well as a Greek minority. Romania has substantial Hungarian and Gypsy minorities and a shrinking population of ethnic Germans.

The Bulgars settled Bulgaria in the 7th century when they crossed the Danube. There was continuous conflict with the Byzantine Empire until the Ottoman Empire conquered Bulgaria in the 14th century. The Turks then administered Bulgaria until 1878 when they abandoned the country. Bulgaria regained full independence with the establishment of a kingdom in 1908. Bulgaria became increasingly dependent on the Habsburg Empire for its protection and had to appeal to Austria when

“The enemies of Bulgaria- Serbia, Greece, Romania, and even Turkey - started a war against her in June 1913”(Gildea, 1987, p. 417)

This threatened intervention stopped the war but it put Bulgaria firmly into the alliance of Germany and Austria-Hungary when the First World War started. Even though Bulgaria was allied with Germany in both World Wars, it managed to retain its identity as an independent kingdom until the end of the Second World War. It was, however, only ruled by the monarchy in name and was frequently engulfed in internal struggles.

The Romanian kingdoms had seen themselves as the defenders of Christendom<sup>38</sup> but could not hold out against the superior Turkish forces. Thus the Ottoman Empire also occupied Romania but with the disintegration of the Ottoman Empire, it became an independent country in 1862 by uniting Moldavia and Wallachia. In 1866 it became a kingdom and remained on the

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<sup>36</sup> Notable revolts took place in 1907 and 1917 but the Polish and Baltic independence movements were active throughout the occupation.

<sup>37</sup> There are about 85% Bulgarian orthodox and about 13% Muslims in terms of religious background.

<sup>38</sup> Notably Vlad the Third (the Impaler) of Wallachia who provided the origins of the Dracula mythology.

sidelines in the First World War, despite having close economic ties with the German Empire:

“That Rumania did not join the First World War on Germany’s side was of great consequence, as Germany considered Rumania - as was the case with Turkey - an outpost of their economic commitment in the Balkans and the Near East” (Koch, 1972, p. 147).

It could thus add Transylvania, Bessarabia and Bucovina to its territory after the war. The inter-war period was characterised by increasing nationalism and fascism which finally lead to an alliance with Nazi Germany which will be examined in more detail in the next section of this analysis.

## Chapter 2: Historical Development

### c) Inter-war period and Second World War

During the inter-war period, the history of the applicant countries is characterised by a high degree of instability and uncertainty. The intentional design of buffer zones between major powers, especially to control Germany, created a number of independent Eastern European countries:

“... the multiplicity of new states had created a regional system of international relations that in theory could be brought into the larger European Balance in order to help restrain any German threat that might arise” (Newman, 1968, p. 14).

This did not prevent internal upheavals, nor did it create a lasting peace. The balance of power, which was supposed to prevent major conflicts, did in the end drag almost all European countries into the Second World War. The differences between the applicant countries in this period are significant in their later development, but one can also note that there are a number of similarities. These similarities include a general reorganisation of Europe caused by the momentous changes in the central European powers, creating instability and uncertainty.

“The states of East Central Europe were weak and divided” (Davies, 1997, p. 976).

Furthermore, the economic upheavals towards the end of the 1920s and the beginning of the 1930s made an impact throughout Europe. The political division of Europe was foreshadowed by a number of uprisings and revolutions; some were successful, some failed with bloody consequences:

“After the Russian Revolution of 1917, Communist parties sprung up in one country after another. Commenting on the mass strikes of the first two years of peace a French publisher lamented “We are reaching the end of our civilisation and we are going to be destroyed not by the barbarians without but by those within” (Merriman, 1996, p. 1144).

It should, however, also be noted that this period was not entirely a negative experience. The CEECs enjoyed unprecedented independence combined with guarantees for their future existence by major European powers. There was some economic development and a cosmopolitan middle class emerged:

“Although the post-war period was one of political instability and a rather poor degree of international co-operation, the performance of the European economies was not too bad in the 1920s” (Cipolla, 1976, p. 450).

But this rebirth of Europe was short-lived, as the unresolved issues of the First World War started to dominate the political scene. This was demonstrated by the political successes of fascism and totalitarianism in many countries. In fact, with the sole exception of Czechoslovakia, all applicant countries experienced some form of dictatorship in the inter-war period. These issues contributed substantially to the Second World War and the total destruction of the European political system of the post-war years. This illustrates the extreme break with the past and the arrival of the new Cold War system. These historical developments demonstrate the instability and uncertainty in the history of the applicant countries. Furthermore, the lack of democratic tradition and the influence of economic developments on political events is noticeable throughout the history of the applicant states.

The countries in Group 1 were deeply affected by the end of World War I. Poland was reconstituted as an independent country while Hungary and Czechoslovakia emerged from the break-up of the Habsburg Empire in 1918 and the settlement in the Treaty of Versailles and the other treaties associated with it<sup>39</sup>. Czechoslovakia became one of the so-called ‘successor states’ of the Habsburg Empire while Hungary was cut down to a much smaller state. Hungary had lost 70% of its territory in the Treaty of Trianon and it

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<sup>39</sup> The war officially ended in a series of treaties, each named after a suburb of Paris.

“left more Hungarians living beyond the borders of Hungary than within”(Merriman, 1996, p. 1152).

Czechoslovakia included substantial German and Hungarian minorities and Slovaks were disenchanted with their minority role in the new state. Poland was created including significant minorities, among them Germans, White Russians and Ukrainian, leading to continual territorial struggle with its neighbours.

Poland quickly became a dictatorship in the inter-war period. General Joseph Piludski, who was a hero of the independence movement against the Red Army, became head of state. The economy was in ruins and hyperinflation was rampant. The parliamentary democracy was unstable and, after resigning in 1922, Piludski overthrew the parliament in 1926 and became a dictatorial leader until his death in 1935. The country remained in a state of crisis. In 1939 Hitler demanded the hand-over of certain Polish territories<sup>40</sup>, leading to the Polish government's readying of defences, as well as the signing of a treaty with Great Britain. When Germany invaded on the 1st of September 1939, it marked the start of the Second World War. Poland was attacked by the Soviet Union in the East and the country was quickly divided between Germany and the SU<sup>41</sup> after Poland was defeated. When Germany attacked the Soviet Union, Poland came completely under Germany's control. Poland and her Jewish population suffered heavily in the following years and it paid the most heavy toll in relation to its population of all European countries. When the tide turned in Russia and the Red Army pushed back the German forces, they reached what used to be the Eastern Polish border in February 1944. The Soviet army liberated the country but it made sure that it came under communist control. When Warsaw rose up against German occupation, depending on support from the advancing Red Army, it was crushed while the Soviet Union was content to wait within view of the city. A

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<sup>40</sup> In particular the port of Danzig as well as access to the Polish corridor.

<sup>41</sup> The division had been previously decided by the secret part of the Molotov-Ribbentrop agreement.

coalition government was established under Soviet domination and Poland became another Soviet satellite in Eastern Europe.

Following the break-up of the Habsburg Empire, Hungary was engulfed in internal struggle. In March 1919, Béla Kun, a communist journalist, seized power with a Soviet agenda. He was overthrown with the help of the Romanian army, which objected to Hungary's occupation of Slovakia, and Nicholas Horthy came to power in 1920, who encouraged attacks on the Jewish population as well as communists and workers. He appointed a Fascist Prime Minister in 1932 but subsequently repressed right-wing parties to maintain his own power. Hungary finally joined the axis in 1940, but continued to be an unreliable ally for Nazi Germany. It did, however, remain within the axis until the Soviet Union swept through Eastern Europe establishing a communist regime in the occupied countries. Hungary faced the same fate as most CEECs after liberation and a Soviet dominated coalition was installed.

Thomas Masaryk governed Czechoslovakia, formed in 1918. He was a popular philosopher in both parts of the country and it remained a democracy, the last Eastern European state to remain democratic, until being carved up by Nazi Germany. Despite the ethnic differences within the state it was a stable, parliamentary democracy which was based on a liberal tradition and a strong middle-class, until being brought down by external forces when Hitler carved-up the country in 1938. The pressure on Czechoslovakia to cede the territories with a German majority population, as well as ceding parts of Slovakia to Hungary and Teschen to Poland, became impossible to resist when the Western powers attempted to appease the Nazi regime at the Munich conference in 1938:

"In the circumstances Prague had no choice but to submit" (Bruegel, 1973, p. 298).

Germany did, however, go further in 1939 and invaded the country. The Czechoslovak army, standing alone, was outnumbered and surrendered without a substantial fight thus removing a considerable military force on Germany's Eastern side. The allies did not react in time:

"After the occupation of Prague, the British army undertook to prepare thirty-two divisions - a force comparable in size to the Czechoslovak army which had been surrendered to Germany without a fight" (Newman, 1968, p. 122).

Germany established the 'Protectorate of Bohemia and Moravia' (directly ruled by German governors), as well as an 'independent' Slovakia, and Czechoslovakia ceased to exist until it was liberated by the advancing Red Army. Slovakia gained independence, albeit orchestrated by Germany:

"Blackmailed by Hitler's threat to hand the Slovaks over to Hungary, Slovak 'independence' was declared ... " (Bruegel, 1973, p. 306).

As a fascist state, Slovakia continued to support the German dominance of the region until the advancing Soviet forces finally drove out the German army.

Slovenia became part of the newly formed Yugoslavia<sup>42</sup> after the Great War. The conflict in Yugoslavia was determined by the vision of a 'Greater Serbia' on the one hand and a federalist state on the other - this issue was never resolved satisfactorily. Having become a parliamentary monarchy it turned into a dictatorship in 1929, when King Alexander took absolute power. A Croatian nationalist, closely associated with the Fascist Ustasca, assassinated him. Hitler invaded and divided the Yugoslav State, and Serbia ceased to exist. The brutal fascist regime of the Ustasca ruled the central part of the country while Slovenia was divided up. Resistance against the fascist regime and later against an invasion force of Germans and others was particularly strong in Yugoslavia and it helped to defeat Germany, militarily, at a great cost. Josip Broz, a communist activist, known as Tito, became the

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<sup>42</sup> It finally became known as Yugoslavia, being termed differently previously.



dominant leader of the resistance and when the occupation was expelled he became the leader of the reconstituted Yugoslavia.

Estonia, Lithuania and Latvia gained their independence from Russia in the Treaty of Versailles. They asserted their independence from Russia in the resulting Russian Civil War and established their own governments. The Baltic States became formal members of the League of Nations in 1921, which recognised their statehood. They enjoyed unprecedented independence in the following years despite being squeezed between Germany, Poland and the Soviet Union. The Baltic States shared a number of similarities in the inter-war period. Being strongly anti-Communist, any communist activity was forbidden in Latvia and Lithuania throughout this time and in 1924 a failed Soviet coup led to a further ban in Estonia. Despite enjoying a successful economic and cultural era, the political systems in this region were unstable. Lithuania was ruled by a nationalist regime from 1926 onwards, after an army coup d'état established Antanas Smetana as the new head of state. Both Estonia and Latvia followed down the same route to dictatorship in the 1930s, following the disastrous downturn in the international economy. In Estonia a new constitution in 1933 was followed by Konstantin Päts assuming dictatorial powers in 1934. In Latvia, Karlis Ulmanis assumed dictatorial powers in 1934. There was some political and economic co-operation between the Baltic States but they came under increasing pressure in the 1930s from the Soviet Union and Nazi Germany. Lithuania came under increasing pressure from Nazi Germany in 1939 and had to give up the Baltic port of Memel. The Baltic States were occupied by the Soviet Union in 1940, after having to accede to previous Soviet ultimatums. They were occupied again by the advancing Wehrmacht in 1941. In 1944 they were finally recaptured by the Soviet Union and were integrated within the Soviet State despite resistance of the population.

Bulgaria lost territories to Greece and Germany in the Treaty of Neuilly for supporting Germany in the war. A monarchy in name only, it was first ruled by Alexander Stamboliski who assumed dictatorial powers. He was

deposed by the army and was slaughtered by Macedonian nationalists. Political life was characterised by assassinations and coup d'états were followed by a dictatorship in 1935. It gained territories from Romania at the beginning of the Second World War and formally joined the axis in 1941. Bulgaria supported the German regime until military defeat started to become a distinct possibility. It stopped the war against the allies unilaterally in 1944, but the Soviet Union declared war anyway, and a popular uprising brought a Soviet-controlled coalition government into power.

Romania, having been on the winning side of the war, gained substantial territories. The monarchy survived the First World War but became increasingly beleaguered by the Fascist movement within the country. The king, Carol II, clamped down on the fascists in 1938, especially the notoriously brutal 'Iron Guards', by establishing a dictatorship. But increasing pressure by Germany led to the abdication of Carol II in favour of his son Michael in 1940, after some territorial losses to other Eastern Europeans and the Soviet Union. Germany occupied the country to secure its oil fields and instated Ion Antonescu to run a fascist state, which soon joined the axis. Romania abandoned the axis in March 1944, faced with the seemingly unstoppable advance of the Red Army. King Michael ended Antonescu's regime in August and declared war on Germany but in the same month the Red Army occupied the country.

The CEECs were thus characterised by an increasing tide of dictatorship and fascism in the inter-war period, culminating in the Second World War. They all became part of the Soviet sphere of influence towards the end of the Second World War, driven by the unstoppable advance of the Red Army.

## **Chapter 2: Historical Development**

### **d) The Cold War**

The immediate post war history of the applicant countries is characterised by the consolidation of power by the Soviet Union. The Red Army had occupied most of Central and Eastern Europe and the Soviet Union used this presence, directly or indirectly, to install pro-Communist regimes. The Cold War is particularly important for the transition and the subsequent accession process. The 40 year dominance by the SU created political and economic structures, which, in part, persist to the present day. The reforms of the 1990s, and the firm wish to be integrated into Western Europe, can only be understood by detailing the historical developments of the last 40 years. For a comprehensive examination of the Cold War see Brogan (1990), a book used throughout this section.

The Baltic States had been occupied in 1940 after surrendering to Soviet ultimata. The Soviet Union, under Stalin, swiftly established puppet regimes and many prominent citizens were deported. The dissolution of independent parties and organisations and their replacement with worker councils was the first step in preparation of an election. This election had only Soviet-friendly candidates on the party lists and duly produced majorities of over 90% for the communist parties. These newly constituted assemblies immediately applied to the USSR to be admitted as member states. In August of 1940, the Baltic States ceased to exist as independent states for almost 50 years. In July 1941, the German armies occupied the Baltic States and started the deportation of the Jewish population of which about 90% perished in the holocaust. When the Soviet Union recaptured the Baltic States in the summer of 1944, Stalin swiftly re-established his authority. Mass deportations followed and once again the Baltic States were incorporated into the USSR. Despite the severity of the Soviet regime, anti-Communist guerrillas fought on against the odds for 10 years but never seriously challenged the occupation forces:

“The partisans concentrated on maintaining their position, reducing local communist control in the countryside, and punishing collaborators and informers; in other words holding out for as long as possible in the hope of outside intervention” (Lieven, 1993, p. 89).

This help never came.

Forced collectivisation was continued in 1949 and by 1950 the Baltic States were completely integrated into the Soviet Union. Information about the Baltic States was hard to come by during the Cold War as the Baltic States were effectively functioning as part of the Soviet Union. The cracks in the political system only started to show in the late 1980s and early 1990s, heralding the beginning of the end of the Soviet Union.

The southern neighbours of the Baltic States did not escape the Soviet Union's influence. Poland had already been partially occupied by the Red Army under the secret Molotov-Ribbentrop Protocol that divided Poland between Germany and the Soviet Union in 1939. The Soviet Union had recaptured the territory lost earlier in the war and came to occupy Poland and most of East Germany. Hungary and Slovakia, both under a Hitler friendly regime, were captured and occupied by the Red Army on her advance to the West. The protectorate of Bohemia and Moravia was liberated from German occupation by a combined effort of Soviet and US troops as well as communist-led resistance and the US troops pulled out to leave Prague to be occupied by the Red Army. The Munich Agreement, which had partitioned Czechoslovakia, was declared void and thus Czechoslovakia was reconstituted. Despite having a free election, Stalin used his influence to introduce a communist dominated government and from 1947 onwards the government faithfully followed the Soviet Union until the revolutions in 1968 and 1989.

Poland had suffered proportionally more than any other country in the Second World War. The liberation by the Red Army did not stop the suffering

of the Polish people. The Soviet Union systematically purged those "Bourgeois" elements of the population, thus quelling potential resistance to the communist taking of power. Despite their numerical disadvantage, Polish guerrilla forces continued to fight the Red Army for three years after the official end of World War II. The territory of Poland was moved westwards and former German populated areas became Polish, while Eastern Polish parts were incorporated into the Soviet Union. The large scale displacement of the German population followed. In the early years of the occupation, the Soviet Union treated Poland like an integral part of the USSR. Formerly German factories were looted and shipped to the East as reparations. The government was set up including Soviet friendly appointments in key posts. When the communist resistance leader, Gomulka, was replaced by a Stalinist, Bierut, Poland had effectively become a Stalinist satellite. The Catholic Church, which had been the one constancy in Poland, was banned and ruthlessly suppressed.

After 1948, private enterprise in Poland was swiftly disbanded. Collectivisation of agriculture was introduced and heavy industry became a priority, especially the production of iron and steel. Mines and industry in the former German territory of Silesia were further developed and the ship building industry was built up around Gdansk. The Soviet Union did not, however, have the tight grip on Poland that it developed in other satellite states. The mass purges associated with Stalinist regimes were avoided and collectivisation had to be abandoned after a slow start. The death of Stalin in 1953 sparked small-scale revolts around Eastern Europe, especially in East Germany. In response, the communist regime intensified the persecution of the Catholic Church and executed a number of dissidents. The situation did, however, improve later on and in 1954, Gomulka was released from prison. After Krushchev delivered his speech on Stalin's crimes, Bierut died and the old Stalinist cadre was purged. These upheavals culminated in some worker demonstrations in 1956, which were ruthlessly crushed. But when Gomulka took power again, the Soviet Union ordered in troops from neighbouring

countries. Krushchev was convinced not to use force by an assurance of loyalty by Gomulka. This defiance set off the Hungarian revolution, which resulted in the invasion of Hungary by Warsaw Pact troops. Gomulka held on to his position until the late 1970s albeit by using anti-Semitic tactics, when threatened by an anti-Semitic 'Partisan' group, and by supporting the invasion of Czechoslovakia in 1968. Germany's attempt at reconciliation with its Eastern neighbours under the social-democratic chancellor Willy Brandt (a policy dubbed 'Ostpolitik') resulted in the final recognition of the Polish-German border in 1970.

The increase in food prices in the same year sparked strikes in the shipyards of Gdansk, which were met with force. But the whole area on the Baltic came out in support and, as a consequence, Gomulka was replaced by Gierek. Gierek negotiated with the workers and ultimately the price rises were revoked. But the workers in the shipyards, and elsewhere in Poland, had their first taste of victory, a development that was crucial for their later actions in the 1980s. The disastrous economic policies in the 1970s, together with the oil shocks, caused further disruption. Furthermore, Cardinal Wojtyla was elected pope in 1978, re-emphasising the role of the Catholic Church, challenging the communist anti-clerical stance. The economic crisis came to a head in 1980. Food prices were set to rise again and the workers in the Gdansk shipyard went on strike, occupying the shipyard itself. The government held a round table talk with the strikers and supporting organisations, which was televised. The government was too weak to resist their demands and all of their demands were ceded including the right to form free trade unions and to strike. These trade unions across the country became known as "Solidarity" groups, or *Solidarnosc*. The communist government had suffered an embarrassing defeat and, by extension, so had the Soviet Union. The Warsaw pact reacted to the apparent weakness of the Polish Communist Party and troops were concentrating on the borders of Poland ready to invade the country if need be. But the moderation of *Solidarnosc* and continued negotiations averted the threat of invasion.



Solidarnosc continued to gain strength and in 1981 the Communist Party, after prompting from Moscow, reacted. The reformers were removed from public office and Jaruzelski became Secretary General. After the Solidarnosc movement directly criticised the economic regime, a state of emergency was declared and Solidarnosc was banned and its leaders arrested. Workers' revolts were crushed by force. But the grip on power of the Communist Party was becoming increasingly tenuous. Throughout the 1980s they tried to accommodate Solidarnosc's demands and thus attempted price rises were abandoned in 1985. In 1987, a referendum for reforms was held, but the government lost - unheard of in the communist bloc - and reforms were also abandoned. By 1988, the economic situation had become untenable. Inflation was spiralling out of control and in May the workers in Gdansk went on strike once more. The Soviet Union, with the new Secretary General Gorbachev, did not seem willing to become involved in domestic struggles any longer. After further strikes throughout the year, Solidarnosc was legalised and round table talks commenced. The final revolution against the communist regime had begun.

Hungary had already attempted to throw off the Soviet domination in 1956 but had been crushed by Warsaw Pact tanks. The communist era had begun in Hungary when Soviet troops occupied the country at the end of World War II. After the atrocities of the war, the Red Army was welcomed but soon the deportation of anti-Communists began. The communists were a small party, but they were backed by the might of the Red Army. They returned from exile in Moscow, being staunchly supportive of Stalin. In an emerging pattern, the Soviet Union established a government with key positions being handed to the communists. In a free election in December 1945, the communists only received 16.9% of the votes. But by 1946, the coalition government was in serious trouble. Inflation was completely out of control and

"Hungary attained the world record in inflation: the 1931 gold pengo was valued at 1.3 quintillion paper pengos" (P. Brogan, 1990, p. 119).



Marshall Aid was turned down after instructions by Stalin, but the people were starving as farmers refused to sell their produce for the worthless currency. Despite losing another election, the communists under Rákosi took power by 1948. A purge, prompted by developments in Yugoslavia, followed, which included another prominent Stalinist, Rajk. This was followed by another purge in 1951. These purges were the most violent in Eastern Europe and they only ended with Stalin's death in 1953. In that year, the new Soviet leadership decided to replace Rákosi with Imre Nagy. He suspended collectivisation and even redistributed land back to the farmers. Economic reforms were introduced but in 1955 Moscow replaced Nagy with his main rival Rákosi. This was the spark, which set off the Hungarian uprising. After Khruchev's secret speech and the developments in Poland, Gero replaced Rákosi. The Polish crisis, described earlier, provided the backdrop to the Hungarian uprising. After Khruchev had backed down in Poland, students in Hungary started to protest to attain reforms. A mass demonstration was called and went ahead despite Gero's attempt to ban the meeting. When Gero gave a speech to the masses, the situation turned violent and several students were killed. But the students, being joined by police, army and party militia, stormed the building. Battles with the secret police ensued and the secret police was defeated. Nagy was persuaded to head a new government and to broadcast to the protesters to restore calm in the city. But the protesters did not retreat and the Soviet Union decided to intervene. On The 24th of October, Soviet tanks invaded Budapest. The fighting was ferocious. Nagy persuaded Krushchev to pull out the tanks and once this announcement was made, the revolution gathered momentum. The hated secret police were hunted down and workers and peasants took control of factories and farms. Within a few days, the Soviet friendly regime had been swept from power.

But the Soviet Union was not yet defeated. Nagy demanded the retreat of Soviet troops from Hungary and decided to pull out of the Warsaw Pact.

The Soviet Union prepared for attack. By the 1st of November an invasion was under way and the Nagy government reacted by issuing the formal withdrawal of Hungary from the Warsaw Pact. Talks resulted but ultimately the decision was already made. On the 4th of November, Soviet tanks entered Budapest by force. Resistance to the invasion was swiftly exterminated and Kádár was installed as the new head of government. Nagy had taken refuge in the Yugoslav embassy but was lured out and arrested. After a trial in Romania, the Red Army executed him and some of his closest advisers. Purges followed in which Hungary was brought back into line with Moscow. The Hungarian uprising was over and despite promises by the new government, Hungary was to remain firmly in the Soviet fold for more than 30 years. But Kádár had to introduce some reforms in the 1960s as the economy took a long time to recover from the uprising. Hungary thus got some free enterprise, which made it more prosperous than many of its Eastern European counterparts. But collectivisation meant poor productivity in farming and the oil crisis aggravated Hungary's foreign debt problem. By the mid-1980s the economy was in serious trouble. An attempt at reform and a new government in 1988 failed to address the problems and the communist regime started to disintegrate. The radical reformers took power in 1989 and Nyers became Prime Minister. These radical reformers started to dismantle the communist state and by 1989 the Communist Party in Hungary was on its way out.

Czechoslovakia also experienced an abortive revolution in 1968. But it started from very different premises. The Communist Party in Czechoslovakia was very strong after the end of the Second World War. Gottwald was installed as head of government and by 1948, the Communist Party had established dominance by instigating a worker's coup. The Communist Party remained loyal to the Soviet Union and inevitably purges and show-trials followed, under the direction of Soviet agents. The death of Stalin, and the death of Gottwald in the following week, did not end the overt persecution. Even the execution of Beria, the notorious head of the KGB, did

not end the purges. The last victims of the purges were only released in the late 1950s and the final rehabilitation only occurred in 1963. Despite similar economic problems, the Hungarian uprising in 1956 did not trigger any large-scale protest. Czechoslovakia remained in the grip of the Communist Party for over 40 years with one memorable exception. In Slovakia, which partially resented the continuation of the Czechoslovak nation, the Communist Party did not provide the same stability as in the Czech Republic. The party appointed Dubcek as Slovakian party secretary. Dubcek managed to establish a power base and after an abortive attempt to introduce a new price system in 1967, he challenged Novotny for the party leadership. After the Soviet Union refused to back Novotny's leadership by force, he resigned and Dubcek became party secretary.

His reforms, which were introduced in an "Action Programme" in 1968, inspired hope in Eastern and Western Europe. He proposed to rehabilitate all the victims of the Stalinist purges and to reintegrate the Slovaks into the Czechoslovakian system. The role of the party in government was to be re-evaluated and, crucially, press censorship was abandoned. The press heavily attacked the excesses of the Novotny regime, helped by the defection of a hard-line security officer to the West who revealed details of the attempted Stalinist coup of Novotny. The Warsaw Pact was becoming nervous and convened in Dresden to discuss the situation. Dubcek was criticised and he subsequently promised to control the press, but he did not impose censorship when he returned to Prague. The period, which followed, became known as the Prague Spring. The Action Programme was soon surpassed by press demands with the placid support of the reformers in government. The leading role of the Communist Party in government and public life was under threat and scheduled party elections were sure to return reformers to power. In a show of strength, the Warsaw Pact held large-scale military manoeuvres in Czechoslovakia and the troops remained after the exercise was ended. A manifesto was published in Prague by leading intellectuals calling for a continuation of reforms despite the threat of foreign

intervention. On the 15th of July 1968, Dubcek was summoned to Warsaw to defend his actions but he refused to attend. A subsequent invitation to the party committee to meet Breshnev in Moscow led to a meeting in Czechoslovakia. Dubcek was heavily criticised by Breshnev and the issues were not resolved.

Once again Soviet tanks were used to stop a reform movement. On the night of the 20th of August 1968, Soviet and Warsaw Pact troops invaded Czechoslovakia in force. The resistance was quickly overcome and the communist Presidium was arrested and flown to Warsaw and onwards to Moscow. Despite having established military superiority, the Soviets could not find a new government as even the hard-line communists refused to co-operate, in the face of overwhelming public opinion against the invasion. Dubcek was returned to Prague after making vital concessions to the Soviet Union. But the public continued a small-scale resistance against the invasion, including pirate radio stations, sabotage of food supplies and railways and the removal of all street signs and house numbers. But Dubcek could not resist the Soviet domination and progressively the resistance was stamped out. The suicide of Jan Palach, a student who set himself on fire in the centre of Prague, and a riot after the Czechoslovakian team beat the Soviet Union at ice hockey, resulted in the removal of Dubcek to a ceremonial post and Husák came to power. The Prague Spring was finally over and after demonstrations on the first anniversary, emergency laws were passed which suspended all civil liberties. Dubcek, who continued to resist the changes, was first removed from the Presidium and then from the parliamentary chairmanship. After a brief stay as ambassador in Turkey (from which he returned, despite the obvious hope that he would defect), he was expelled from the party and became a worker in Bratislava where he remained for almost 20 years.

The invasion had established what became known as the Breshnev Doctrine. It stated that the Soviet Union would use force when it felt threatened by internal political processes in an allied country. In particular, the doctrine made it clear that the states of Central and Eastern Europe would

remain under Soviet control under any circumstances. This doctrine remained in force until Gorbachev revoked it 20 years later. In Czechoslovakia, the results of the invasion were further purges concerning all aspects of public life and the hard-line communists established a stranglehold on the country. The only resistance came from intellectuals and, the economy - once among the most advanced in Europe - began a decline characterised by lack of investment. The intellectuals published "Charter 77" in 1977, which demanded democratic rights. Writer Václav Havel was their most prominent voice. But these protests were suppressed and the dissidents were harassed and prosecuted. Only after the retirement of Husák and the rise to power of Gorbachev could the democratic forces once again become prominent. After protests in 1988, the 20th anniversary of the Prague Spring, in 1989, inspired by other Central and Eastern Europeans, saw the communist regime swept from power in the so-called Velvet Revolution.

In South-Eastern Europe and the Balkans, the transition of power did not happen as suddenly. Bulgaria, the staunch ally of the Soviet Union, did not reform decisively until long after the other countries in the region had risen against communism and the Communist Party remained in power. Romania suffered the bloodiest of all revolutions after being ruled by a megalomaniac dictator and Slovenia's reform and independence was soon marred by ethnic conflict, which persists in the region until the present day.

In Bulgaria, the communists came to power after the Red Army occupied the country. The Communist Party had no significant power base within the country but it used the Soviet allies to intimidate any opponents. Bloody purges were carried out in 1944 and 1945 and prison camps were set up resembling the gulags in the Soviet Union. Most of the previous elite was killed or removed from public life and Bulgaria's communists held on to power until the 1990s. After the Second World War, democratic parties withdrew from the government and refused to participate in rigged elections. From then on, the Communist Party ruled absolutely. Dimitrov, the first party leader, died in Moscow in 1949, but Bulgaria remained the Soviet



Union's faithful ally and Moscow even used the Bulgarian secret service to conduct difficult and controversial operations. After a short interlude by Kolarov, Chervenkov became general secretary. The death of Stalin resulted in a changed course in Bulgaria and in 1954, Zhivkov became general secretary. Under Zhivkov, Bulgaria became an extension of Soviet policy, including economic policy, which led to a long-term deterioration of the Bulgarian economy. Apart from an abortive coup in 1965, and some ethnic disputes with the Turkish minority, the grip of the Communist Party on power never wavered. Zhivkov remained in power and did not follow the reforms introduced by Gorbachev in the late 1980s. But the events in the rest of Eastern Europe, and some small-scale protests in Bulgaria itself, convinced the party leadership of the need for reform. Zhivkov was removed from power and democratic reforms were introduced. Bulgaria conducted the quietest revolution but as a result the reforms were instigated half-heartedly and Bulgaria continued to lag behind the other countries in the region.

Romania, on the other hand, continued to suffer from violence. Having been an ally of Hitler in the Second World War, Romania lost large amounts of territory. After the king had removed the dictator Antonescu in 1944, the Red Army liberated and occupied the country. The communists which had escaped to Moscow were supported by the Soviet Union, as elsewhere in Eastern Europe and they demanded key posts in the government appointed by King Michael. The Soviet Union supported their claim by surrounding the Royal palace with troops and tanks. King Michael appointed Petru Groza but attempted to resist the gradual encroachment of the communists. Yet he was powerless to halt the communist seizure of power. When public demonstrations forced the acceptance of some non-communists ministers, the communists instigated a fraudulent election in 1946, in which, predictably, they gained a huge overall majority. Opposition was swiftly oppressed and in December 1947, the last major opponent of the communist regime, King Michael, was forced to abdicate and flee the country. In accordance with the Soviet Union, the communists forced collectivisation and encouraged heavy

industry. Gheorghiu-Dej, who spent most of the war in prison, became the general-secretary of the party but it was still dominated by the communist faction from Moscow. Only in 1951 did he truly become the central figure and duly, he purged the party of opponents in the following year. The death of Stalin enabled a small-scale reconsideration of the disastrous economic policies, which had brought agriculture, the dominant economic force in Romania, to a stand still. But the general economic policies remained and over subsequent years, Romania was to become one of the poorest countries in Europe. It was also plagued by nationality disputes with ethnic Hungarians, Germans, Tartars, Turks and Serbs, who were persecuted to varying degrees. Romania managed to attain some independence from Moscow in the following years. Despite issuing a formal declaration of independence in 1964, retribution did not follow. Romania had achieved some degree of autonomy but it did not manage to reform itself. On the contrary when Gheorghiu-Dej died suddenly in 1965, Nicolae Ceaucescu succeeded him. Ceaucescu, who had been undistinguished previously, quickly consolidated power. In 1967, he made himself President and his wife, Elena, also started to become prominent in the party hierarchy. Despite the continued independence from Moscow, the situation within the country deteriorated. Ceaucescu and his family were becoming increasingly megalomaniac and a personality cult developed. He enriched himself by taking whatever he wanted from the state and no opposition was tolerated. In a number of increasingly ludicrous projects, the state wasted billions of dollars and a large part of Romania's heritage was destroyed. The secret police, the Securitate, became increasingly oppressive, and the country became more and more isolated. Birth control was banned to increase the population and the economy deteriorated. In 1980, Ceaucescu decided to eliminate foreign debt. Exports, especially of agricultural goods, were accelerated and imports were banned. In consequence most Romanians lacked the most basic essentials, including food and medical supplies, while the Ceaucescus lived in a surreal world of luxury. He also demanded



complete obedience from all surrounding him. Despite periodic protest, ruthlessly suppressed, Ceaucescu remained in absolute power.

Only in 1989, after protests of prominent communists and the developments in the rest of Eastern Europe, did the wind of change reach Romania. In Timisoara, the Securitate crushed protests and a large number of people were massacred. But the demonstrations continued. When Ceaucescu returned from a state visit to Iran, he and his wife were arrested and subsequently tried and executed. Battles continued between the Securitate on one side and the army and demonstrators on the other and small-scale civil war erupted. In the end, the Securitate was overwhelmed and the Romanians could finally rebuild their state. But the suspicion has persisted that the revolt was a palace revolution rather than a real democratic process and "reformed" communists took power in following years.

Slovenia attained independence as a result of the upheavals in the late 1980s. But like all of the component parts of Yugoslavia, these changes did not occur peacefully, albeit Slovenia did manage the cleanest break from the Serb-dominated federation. Yugoslavia was only created in 1918 and, in reality, no longer exists. But after the Second World War it was seen as the best hope for peace in the Balkans. After the invasion of Yugoslavia by Hitler in 1941, violent and brutal resistance and oppression dominated Yugoslavia. The partisans tied up a large number of divisions, which Hitler could not utilise in other battles of the Second World War. Yugoslavia was divided up between Germany, Italy and an independent, fascist Greater Croatia, which distinguished itself by being one of the most brutal regimes in modern history. Slovenia itself was divided between Italy and Germany and ceased to exist. Mihajlovic, an army general, lead the officially recognised resistance, forming the Cetniks. But the main resistance was quickly drawn to Josip Broz, known as Tito. Tito, a communist, set up the Partisans in 1941 and after initial successes retreated into guerrilla warfare with the German occupiers who turned increasingly savage to control the resistance. Tito was increasingly successful and Mihajlovic soon linked with the Germans to fight the Partisans.

But Tito prevailed and managed to liberate almost all of the country from the German occupation with some help from the Red Army, which then retreated. Tito was now in control of the country and in fierce reprisals many loyal to the former regime were executed.

Tito had achieved what most other Eastern Europeans did not - independence from the Soviet Union. Yugoslavia had suffered terribly in the war. A large proportion of the population was killed and infrastructure and industry was destroyed. Tito imposed a communist regime along the lines of Stalinism and collectivised industry and agriculture. But Tito defied Stalin only a few years later. In 1948, a dispute erupted over Yugoslavia's foreign policy. Initially Tito wanted to expand Yugoslavia by unifying with Albania and Bulgaria, but Stalin at first rejected the idea. When Stalin changed his mind so had Tito. The Soviets had infiltrated many Yugoslav institutions but unlike the rest of Europe they were dealing with an experienced political and military leadership. When Tito was summoned to Moscow he declined. Stalin attacked his representatives and by March, Stalin had ordered the withdrawal of Soviet personnel. When Tito was summoned to a meeting in Poland, he declined again and was subsequently denounced in the strongest terms. But the Yugoslav party did not rise against Tito. Instead those loyal to Stalin were removed from party ranks. Yugoslavia now stood alone, but soon began to develop closer relations with the Western powers who supplied assistance. By the early 1950s, the economic consequences of Stalinist policies were becoming apparent and "self-management" was introduced, raising the standard of living by allowing some limited ownership. In political terms, Tito remained an absolute ruler and continued to suppress the ethnic disputes in Yugoslavia, albeit less brutally than some Eastern counterparts. Tito's Yugoslavia became a member of the non-alignment movement and, especially after Stalin died, continued relations with both the West and the East. Even though Yugoslavia suffered some economic setbacks in the 1970s, the country was stable until the 1980s.

In 1980, Tito died and soon the ethnic conflicts were flaring up again. In 1981 a massacre committed by ethnic Albanians in Kosovo left many Serbs dead. The Albanian majority in Kosovo continued to protest against perceived discrimination. The collective central government in Belgrade was weak and continued to lose control in the 1980s. By 1988 the Serb communist leader, Slobodan Milosevic, started to agitate publicly against the ethnic minorities within Serbia while inflation spiralled out of control. Democratic elections further divided the country into ethnic groups and the disintegration of Yugoslavia began. Croats in the Knin area rebelled against the Serbs in 1990. When Slovenia declared independence in spring 1991, the Yugoslav army was quickly expelled. The underlying reason for this relatively painless exit can probably be explained, as Slovenia had no substantial Serb minorities within her territories. But first Croatia, then Bosnia-Herzegovina and finally Kosovo all became ethnic flash points escalating into civil war and ethnic cleansing. But Slovenia, the richest of the Yugoslav republic, was spared this fate.

It is thus clear that all the applicant countries, to a degree, share a common history. The rise of communists to power after the Second World War held fast for over 40 years. Their economic policies had led to deterioration in living conditions and by the second half of the 1980s they were ready to revolt. But up to that point the dominant power, the Soviet Union, had shown repeatedly that Moscow was ready to use force when their hegemony was threatened. But the political landscape changed dramatically when Mikhail Gorbachev came to power in 1985. All of the CEECs suffered from economically disastrous policies, albeit some more than others. Furthermore, internal conflicts were kept under control through ruthless authoritarian measures until the revolutions of the late 1980s and the early 1990s.

## **Chapter 2: Historical Development**

### **e) The Revolutions**

The revolutions of the late 1980s and early 1990s are particularly important for the applicant countries. They have enabled the orientation of these countries to the West. Furthermore, the applicant countries were swept away in a wave of reforms, without a clear idea of the endpoint of this revolution. At the conclusion of the unfolding events, there stood a number of free countries with a desperate need to reform their entire political and economic structures. The revolutions in Central and Eastern Europe can be understood best when following a timeline. This timeline starts with the election of Gorbachev. He was a different breed of leader than previous party secretaries, especially after the ancient men incapable of governance in the early 1980s. After consolidating his power within the Soviet Union, he made his first move in 1987. At the summit of Reagan and Gorbachev in Reykjavik, he proposed a radical cut in nuclear weapons by 50%. Even though Reagan did not follow this lead, the treaty on Intermediate-range Nuclear Forces was signed, signalling the end of the Cold War. The reforms proposed by Gorbachev in the Soviet Union became known as “Perestroika” and “Glasnost”. These entailed a liberalisation of press censorship and substantial economic reform. More importantly for the satellite states of Central and Eastern Europe, the Breshnev Doctrine was no longer upheld.

The first developments towards democratisation started in Poland in 1988. After Gorbachev had announced the withdrawal of the Soviet Union from Afghanistan, the Polish opposition, under the still banned Solidarnosc banner, started a number of strikes. The communist government was facing economic ruin and conceded in a televised speech by Jaruzelski that a change had to occur. Solidarnosc was invited to join round table talks to discuss the future of the country. Solidarnosc won the crucial concession that the legalisation of Solidarnosc would be discussed and the strikes were ended. Negotiations between the government and Solidarnosc commenced and

Walesa was even involved in a televised debate with the official union representative. Walesa demonstrated his skills as a politician and was now firmly embedded in the Polish public's consciousness as the leader of the opposition.

1989 started with the resignation of the Yugoslav government, which had come under increasing pressure through nationalistic mass demonstrations organised by Slobodan Milosevic. Protests in Czechoslovakia, commemorating the death of Jan Palach 20 years earlier, were followed by mass arrests of dissidents. Among the dissidents was Václav Havel who was given a jail sentence shortly afterwards. Hungary's communists had seen the signs of the time and allowed the creation of independent political parties in February. But the real development continued in Poland. After the round table talks had commenced officially in February, the government was rapidly losing ground. The communists had to concede the legalisation of Solidarnosc and associated groups, in effect, created a legal, non-communist opposition. Crucially, they agreed to hold free parliamentary elections at least for a limited number of seats. These elections were to be held in June but only 35% of the seats in the lower, and crucial chamber of parliament, the Sejm, would be contested freely. But the Senate of 100 members would be freely elected for the first time. Meanwhile the disintegration of the communist system was spreading.

In March, six retired Romanian party notables published a letter of protest, criticising the Ceausescu Regime. Hungary decided to dismantle their border controls in May of 1989, creating the first decisive break in the iron curtain and Kadar retired as party president. As the Warsaw Pact countries had a limited freedom of movement between the member states, the break in the iron curtain was used by many East Germans to cross into Austria in the summer vacations. Many more started camping out in the grounds of the West German embassy demanding free passage to the West. In a symbolic gesture of appeasement, Imre Nagy was reburied in Budapest attended by the

reform communist government and accompanied by a huge anti-Communist rally in June.

But the main development was still gaining pace in Poland. The election on the 4th of June 1989 produced an unprecedented landslide for Solidarnosc. After the final run-offs, Solidarnosc had won 99 seats in the Senate and the remaining one went to an independent candidate. Of the 161 freely contested seats, Solidarnosc won 160 in the first round of voting and the last one in a run-off. Furthermore, most of the uncontested seats of the communist candidates had such low support that they did not manage to pick up the required absolute majority in the first round. In fact, only 3 out of 173 seats produced the necessary majority and on a separate list of party notables only 2 out of 35 unopposed communists were elected outright. The remainder was only elected after Solidarnosc requested their members to vote for these candidates, to prevent further unrest. The new Sejm elected Jaruzelski as President with a slim majority after the Peasant and Democratic parties deserted the communist bloc. His proposed Prime Minister, Kiszczak, needed the support of minority parties to govern. But Solidarnosc was pushing for power. After Gorbachev reaffirmed his commitment that no interference by the Soviet Union would take place, the way for a Solidarnosc government was open. After the Sejm rejected the communist government, Jaruzelski bowed to the inevitable and appointed Tadeus Mazowiecki as the first non-communist prime minister in Eastern Europe for over 40 years. The monopoly of power of the Communist Party had been broken and the news spread throughout Eastern Europe and even into the Soviet Union.

In Czechoslovakia and the Baltic States, protests were starting to become stronger, marking the anniversaries of the 1968 invasion and the Hitler-Stalin Pact. But the governments there made no movement to reform and the police broke up the protest in Czechoslovakia. But Hungary's government moved even further. After allowing East Germans to leave, a mass exodus started towards the West. Thousands were crossing the border to Austria and even more were coming into Hungary from across the border



from Czechoslovakia. The Hungarian government agreed to hold free elections in 1990 and in October, the Communist Party was reformed as a Socialist party. One more former satellite had a non-communist government in power.

In East Germany the exodus of citizens combined with the 40th anniversary of the formation of the GDR. Growing demonstrations ensued and, finally, the regime ordered the police to fire on the demonstrators. The order was cancelled in the last minute and shortly afterwards, Honecker resigned in favour of Krenz. On the 7th of November, 1990, the government resigned, followed a day later by the Politburo. On the 9th, in a surprise announcement, the new communist government declared the removal of border controls on the West German border. East Germans started moving towards the wall and the border guards, overwhelmed by numbers and without clear orders, opened the border check points. The pictures of the celebrations were transmitted all over the world as East and West Germans met on the divisive wall to celebrate the new freedom; pictures which further fuelled the transition process in the other CEECs. The communist government was powerless and it was clear that East Germany, once the most stalwart of the Soviet Union's supporters, had also fallen to the West.

In Bulgaria the reform movement was also gaining pace. After demonstrations in Sofia, Zhivkov was replaced by Mladenov as Communist Party leader. However, protests continued with a demonstration on the 18th November, demanding free elections. But the next country to attain democracy was Czechoslovakia. A demonstration on the 17th of November, 1990, was broken up by the police. Two days later tens of thousand gathered to protest against police brutality. The Open Forum (OF) formed an umbrella organisation for the emerging opposition. The demonstrations continued daily and every day the size of the crowd was increasing. Dubcek addressed the crowd on the 24th and the whole government resigned. After a 2 hour strike, directed by the Open Forum, on the 27th, the government promised free



elections on the 28th. The 'velvet revolution' had succeeded in removing another communist government from power.

The resignation of the governments of both East Germany and Czechoslovakia in December, 1990, only reaffirmed that power had passed to the democratic opposition. This was followed by the formation of a non-communist government in Czechoslovakia. In Lithuania delegates of the regional parliament also voted to reassess the role of the Communist Party, a courageous move in a country still technically part of the Soviet Union. The Communist Party declared itself independent of the Soviet Union shortly afterwards. Croatia also moved to change the federation by announcing free elections in 1990, followed by Slovenia less than a week later. But the next major development occurred in Romania. After massacres on anti-government protesters in Timisoara, Ceaucescu returned to Bucharest. He addressed a communist rally on the 21st of December, 1990. But the formerly loyal crowd turned against him and he was shouted down. The whole address was televised and it became clear to the country that Ceaucescu has lost his grip on power. The pictures of his incomprehension of the protest, before the state television managed to switch off the cameras, have remained vivid in many peoples' memories. The following day Bucharest and other cities erupted into mass demonstrations against Ceaucescu and the army sided with the demonstrators. Ceaucescu and his wife fled Bucharest by helicopter but were later arrested on an army base, and subsequently executed. The Securitate, which was well armed, attempted to retake power and street battles occurred throughout Romania. But the Securitate was defeated and one of the most reprehensible regimes was removed from power in less than two weeks.

At the beginning of 1990 the political landscape of Europe had changed fundamentally. Havel had been elected President in Czechoslovakia with Dubcek becoming, once again, the chairman of the parliament. Poland started to introduce wide scale economic reform at the beginning of 1990. Bulgaria, forced by the changes occurring around it, revoked the leading role of the

Communist Party in the middle of January. Two weeks later, Zhivkov was arrested, followed by the resignation of the government. In East Germany, Honecker was also arrested and Gorbachev admitted that unification with West Germany was inevitable. The winds of change finally reached the Soviet Union with a mass demonstration against the communists in Moscow, on the 4th of February.

But 1990 was mainly the year of elections. Communists were defeated in Lithuania on the 24th of February and on the 11th of March, Lithuania declared independence. On the 18th of March regional elections in the Soviet Union signified gains for the reformers. On the same day, the first free election was held in East Germany, giving the western-dominated Christian Democrats almost half of the vote. This was a mandate for unification and after German Economic and Monetary Union on the 1st of July, Germany was reunited on the 3rd of October 1990. Latvia and Estonia voted on the 18th of March for pro-independence parties in their first round of elections. This was followed by a declaration by Estonia on the 30th, stating that the annexation by the Soviet Union was illegal. This was followed by a declaration of independence, by Latvia on the 4th of May. In Hungary, an election on the 25th of March produced a democratic government excluding the communists. In Slovenia the election in early April produced a large non-communist majority followed by the formation of a non-communist government - a development replicated by Croatia immediately afterwards. Romania elected a new president, Iliescu, and a new government on May the 20th and in Poland local elections, a week later, removed communists from local authority.

But the transformation had not yet finished. Lithuania was subjected to an economic embargo by the Soviet Union, which cut off crucial oil supplies. In Bulgaria the renamed communists, now the Socialist Party, actually won the election in June. In Albania the reformist movement was just stirring. But the centre stage of development moved East to the Soviet Union and the Baltic States as well as south to the Balkans. The Baltic Republics were pressurised

by Moscow to sign the new Soviet Union Treaty, turning the Soviet Union into a confederation. But the Baltic States were looking for independence. In December 1990, Gorbachev set a deadline for signature for the following summer but the Baltic States refused. In January, matters became critical in the Baltic States. Price rises by the governments led to protest by the Slavic minority. Groups loyal to the Soviet Regime declared themselves independent of the governments. But most noticeable of all, was the arrival of a large number of Soviet troops, mainly drawn from the Ministry of Interiors Special Forces, OMON. These started to occupy key buildings in the capitals and in Vilnius, 14 people were killed when a peaceful protest against the occupation of the television station was dispersed. This was followed by a similar incident in Riga, where a week later six protesters were killed. But Moscow itself was reforming. Boris Yeltsin, the president of the Russian parliament, denounced the crackdown and Gorbachev had to admit that the use of force was not legitimate.

Subsequent referenda in February and March, 1991, returned a resounding vote for independence. Boris Yeltsin remained the most vocal of supporters and the Baltic cause was further helped when in June, 1991 Russia itself declared the intention to leave the Soviet Union. A solution was found by devolving more powers to the republics but before the treaty could be signed, a coup was attempted in Moscow on the 20th of August, 1991. The coup was a badly organised affair and quickly crumbled in the face of resistance. The Baltic republics immediately declared their full independence on the 20th and 21st of August. Gorbachev lost the internal power struggle to Boris Yeltsin. By September, the new government recognised the Baltic States and the republics were admitted to the UN. By December, the Soviet Union had dissolved.

In the space of little more than two years, one of the global superpowers had disintegrated and the satellite states had found their independence. The lid which had kept tension and dissent firmly under control had been lifted and the forces for change were too strong to be

stopped. But notably in one area, as well as in some territories of the former Soviet Union, these changes also brought about the re-emergence of nationalism and ethnic conflict. In Yugoslavia, reform was accompanied by a rise in nationalistic forces. Some of the republics were striving for independence while the Serb centre was becoming more nationalistic under the leadership of Slobodan Milosevic, in power since 1989. After the assembly of Slovenia introduced constitutional changes to include the right to secede in 1989, the real turning point were the free elections of 1990 in Croatia and Slovenia. In April, Slovenia voted for a centre-right government and Milan Kucuk became President. This was followed by free elections in Croatia later in the same month, which were won by the nationalists under Franjo Tudjman. On the 2nd of July, the Slovene parliament formally proclaimed sovereignty. In relatively free elections in the rest of Yugoslavia former communists were elected under the nationalist banner, including Milosevic's re-election in Serbia. After a proclamation, declaring the right to secede of Croatia in December, and a referendum for independence in Slovenia, the Yugoslav forces were put on alert in early January. The Slovene and Croat territorial forces were ordered to surrender their arms within ten days but the military confrontation was avoided when the federal presidency of Yugoslavia countermanded the orders. But the conflict was only postponed. On the 1<sup>st</sup> of March, skirmishes were recorded in Croatia and Milosevic seized power by declaring the end of Yugoslavia. After a referendum in Croatia in May was resoundingly supportive of independence, both Slovenia and Croatia declared themselves independent on the 25th of June, 1991. After the Yugoslav forces tried to take control in Slovenia, the territorial defence fought back and managed to gain the upper hand. After a cease-fire on the 4th of July, the federal presidency was persuaded by a troika of EU foreign ministers to accept a postponement of Slovenia's independence for three months, in effect recognising Slovene secession. For Slovenia the war was over. But for the rest of Yugoslavia the war had just begun. War broke out in Croatia, followed by the multi-ethnic republic of Bosnia-Herzegovina. Serb security

forces, with the Yugoslav federal army and Serb irregulars, waged a territorial war to create a Greater Serbia and resorted to terror and ethnic cleansing. After Croatia gained the upper hand and a patchwork peace was put into place in Bosnia, the conflict shifted to the East. In the Kosovo region the majority Albanian population rose against Serb domination. This followed the same pattern as in the other republics with the exception that, this time, NATO took an active hand and bombed the Serb forces into submission. But the region is far from peaceful and the rebuilding of these countries will take a long time. Fortunately for Slovenia, the conflict did not affect the Slovene territory any further. After Slovenia and Croatia, were recognised by the EU on the 15th of January, 1992 Slovenia became firmly oriented towards the Western alliance.

The revolutions swept Eastern Europe with astonishing speed and the development was surprisingly similar in all the applicant countries, where the removal of the external threat brought democratic forces to the fore. It is clear that the differences between the applicant countries are numerous. There are differences in initial resource endowment, as well as their subsequent history. In particular, some of the CEECs have some limited historical background of democracy and independence, while others have almost no democratic legacy. The same differences are apparent when regarding different experiences of state control of the economy. Finally, the transition started very differently with violent battles in some countries, while other countries experienced almost no open conflict.

Yet it is also obvious that there is a large degree of similarity in the applicants' situation. All the applicants share, to some degree, a similar history, culminating in the Cold War and subsequent revolutions. Furthermore, all of the applicant countries have been subjected to domination and ideology of the larger countries of Europe and have often been caught up in the larger European conflicts. The experience during the Soviet era is particularly formative. This becomes especially clear when regarding the economic deterioration under the communist regimes and the aspirations of

their people to become a democratic and prosperous society. Once the external control was lifted by the Soviet Union these aspirations led to the revolutions, which swept the communists from power.

Thus, by the beginning of 1992, all Central and Eastern European Countries had effectively attained independence, with the exception of Slovakia, which split peacefully from the Czech Republic a year later. These countries subsequently applied to the European Union for membership. Reforms were starting to introduce stable democratic institutions but the economic legacy of communist mismanagement needed to be addressed as well. The predominant wish of these countries, after escaping from Soviet and communist dominance, was to become a member of the Western alliances. The recent democratisation, as well as economic reforms, is discussed in the next chapter with a special emphasis on the relationship between these countries and the European Union.



## **Chapter 3: Reforms and the West**

### **a) Economic reforms and political change**

The revolutions in CEE created the opportunity for a new stage in European integration. The applicant countries made it clear that they wanted to be considered as prospective members of NATO and the EU as soon as possible. Yet many problems remained after the successful revolutions. This chapter examines the transition in the applicant countries and their relationship with the EU up to the present day.

The applicants faced a momentous challenge after the revolutions. The problems they faced were far-reaching and far from easy to solve. The political framework had to be completely remodelled, including new legal and administrative structures. The reforms necessary for the economic restructuring were even more fundamental. All applicant countries had some variant of a planned economy, with the associated distortions of incentives. As a result even the formerly prosperous economies had fallen far behind the memberstates of the European Union. Daniel Daianu notes that the seriousness of the task faced by the CEECs cannot be overemphasised:

“Because frequently one sees allegedly knowledgeable professionals making judgements on the transformation process while seeming oblivious to the heavy legacy of backwardness of these societies, a state of affairs which goes back deeply into history” (in Teichova, 1997, p. 84).

The following tables summarise the situation of the applicant countries early on in the transition. The tables illustrate whether the countries are similar in population (P) and territory (T) to the larger member states, such as Germany, France, Italy, the UK or Spain, or whether they are closer to the small member states such as Luxembourg, Ireland or Denmark. In terms of aggregate GDP (Y) all of the applicants are closer to the low aggregate income member states, such as Luxembourg<sup>43</sup>, Ireland or Greece, or even at a fraction

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<sup>43</sup> Luxembourg is very rich in per capita terms, yet due to its small size Luxembourg has a low aggregate GDP.



of these countries GDP. The first table examines the situation in the Visegrad countries, the Czech Republic, Hungary, Poland and Slovakia.

**Table 3.a.1: Showing the applicant countries in Group 1<sup>44</sup> in relation to comparable EU memberstates according to population, territory and GDP (1992 data).<sup>45</sup>**

{P <sup>46</sup> , T <sup>47</sup> , Y <sup>48</sup> )	Population (P) equivalent	Territory (T) equivalent	GDP (Y) equivalent	Combined population (P)	Combined GDP (Y)
Poland (P 38.365, T 120, 725, Y 75.3)	Spain (P 34.085)	Italy (T 116,303)	Greece (Y 79.2)	Group 1: UK + Denmark  (P 57.848 + P 5.17~ P1 = 64.296)	Group 1: Denmark  (Y 142.1~ Y1 = 141.5)
Hungary (P 10.202, T 35,969, Y 30.7)	Greece (P 10.3)	Portugal (T 35,553)	1/3 Portugal (Y 83.9)		
Czech Rep. (P 10.383, T 30,343, Y 25.3)	Greece (P 10.3)	Austria (T 32,374)	½ Ireland (Y 48.8)		
Slovakia (P 5.346, T18,917, Y 10.2)	Denmark (P 5.17)	Denmark (T 16,629)	Luxem- bourg (Y 10.4)		

The table shows that the more prosperous of the applicant countries were far behind the comparable GDP of current EU member states. The combined population of the Visegrad countries is similar to the combined population of the UK and Denmark; yet the combined GDP was only the equivalent of Denmark’s. The following table summarises the situation for the smaller applicant countries.

44 Czech Republic, Hungary, Poland and Slovakia.  
45 Data adapted from N. Davies “EUROPE”, p. 1332 (Davies, 1997).  
46 P- Population in million  
47 T- Territory in sq. miles  
48 Y- GDP in billion \$

**Table 3.a.2: Showing the applicant countries in Group 2<sup>49</sup> in relation to comparable EU memberstates according to population, territory and GDP (1992 data).<sup>50</sup>**

{P, T, Y)	Population (P) equivalent	Territory (T) equivalent	GDP (Y) equivalent	combined population (P)	combined GDP (Y)
Slovenia (P 2.017, T 7,187, Y 14.4)	1/4 Sweden (P 8.678)	1/2 Denmark (T 16,629)	1/10 Denmark (Y 142.1)	Group 2: Greece (P 10.3~ P2 = 9.942)	Group 2: 1/2 Greece (1/2 Y 79.2~ Y2 = 39.3)
Estonia (P 1.554, T 17,413, Y 5.9)	1/2 Ireland (P 3.547)	Denmark (T 16,629)	1/2 Luxembourg (Y 10.4)		
Latvia (P 2.617, T 24,500, Y 8.9)	1/2 Finland (P 5.042)	Ireland (T 27,136)	Luxembourg (Y 10.4)		
Lithuania (P 3.754, T 25,174, Y 10.1)	Ireland (P 3.547)	Ireland (T 27,136)	Luxembourg (Y 10.4)		

The combined size of the small applicant countries is the equivalent of Greece, but with only half the GDP. Yet from this table it is clear that the EU could absorb these countries from an economic perspective. Their relative small size means that while they would require a relatively large amount of EU funding the problem would be manageable from an economic perspective. Institutionally the small size of these countries would create far-reaching problems, an issue later discussed.

However, for the Balkan applicants the situation is very different. They are relatively large, yet they are the poorest of the applicants. Their position is summarised in the following table.

<sup>49</sup> Slovenia, Estonia, Latvia and Lithuania.

<sup>50</sup> Data adapted from N. Davies "EUROPE", p. 1332 (Davies, 1997).

**Table 3.a.3: Showing the applicant countries in Group 3<sup>51</sup> in relation to comparable EU memberstates according to population, territory and GDP (1992 data).<sup>52</sup>**

{P, T, Y)	Population (P) equivalent	Territory (T) equivalent	GDP (Y) equivalent	combined population (P)	combined GDP (Y)
Bulgaria (P 8.952, T 42,823, Y 11.9)	Sweden (P 8.678)	UK (T 94,226)	Luxembourg (Y 10.4)	Group 3: Spain (P 34.085~ P3 = 31.817)	Group3: 1/2 Greece (1/2 Y 79.2~ Y3 = 36.8)
Romania (P 22.865, T 91,699, Y 24.9)	2 Greece (P 10.3)	Portugal	1/2 Ireland (Y 48.8)		

These countries have a combined population close to that of Spain. Yet their combined GDP was only half that of Greece - the lowest per Capita GDP in the EU. They have serious problems even when trying to catch up with the lowest GDP of the EU, notwithstanding attempting to reach the average.

The following table shows the size of the problem when considering all the applicants together.

51 Bulgaria and Romania.  
52 Data adapted from N. Davies “EUROPE”, p. 1332 (Davies, 1997).

**Table 3.a.4: Showing all applicant countries in relation to comparable EU memberstates according to population, territory and GDP (1992 data).<sup>53</sup>**

{P, T, Y}	Population (P) equivalent	Territory (T) equivalent	GDP (Y) equivalent
All Applicant Countries (P 106.055, T 415,380, Y 217.6)	France + Spain + Belgium (P 57.372 + P 34.085 + P 10.025)	France + Spain + Belgium (T 211,207 + T 194,884 T 11.781)	Belgium (Y 218.7)

The combined picture is stunning. Admitting all the applicants would be equivalent to admitting another France, Spain and Belgium in terms of population and territory. Yet the combined GDP is only equivalent to that of Belgium.

The situation has not improved substantially since the beginning of transition. All applicant countries faced a collapse in industrial output after the revolutions. This was reflected in a large fall in GDP. The causes for this output fall are still disputed, as described in the literature review in Chapter 1. Yet it is clear that most countries struggled to make up the lost ground of the early 1990s. The relative position of the applicant countries’ GDP to the EU has, thus, not improved on average. Convergence is still some way off and the average growth differential to the EU makes catching up to the average EU GDP a decade-long process. The relative poverty of the CEECs makes accession very difficult due to issues such as migration, as well as low wage competition. Yet the situation varies widely within the applicant countries.

The best performing applicant country, Slovenia, still has only 68% of EU average GDP, followed by the Czech Republic with 60%. Hungary with 49%, Slovakia with 46%, Poland with 39% and Estonia with 36% form the mid-field. At the lower end of the scale Lithuania only reaches 31%, while Latvia and Romania only reach 27%. The lowest GDP is still recorded by Bulgaria, which only reaches 23%. When comparing 1998 industrial

<sup>53</sup> Data adapted from N. Davies “EUROPE”, p. 1332 (Davies, 1997).

production with 1995 figures most countries record an increase. These increases range from 29.4% in Hungary to 8.3% in the Czech Republic. However, both Bulgaria and Romania, have lower industrial production than in 1995 with 82.6% and 85.8% respectively. Furthermore, they are still recording a decreasing rate with -12.7% and -17.0% respectively. This has to be contrasted to the fall in output in all applicant countries at the beginning of the transition process. The combined effect suggests that the best performing applicant countries have just recovered their situation at the beginning of the transition process, while the worst performing countries, in particular Bulgaria and Romania, have fallen even further behind.

This is supported by evidence collected in the United Nations' Economic Survey of Europe, which states:

"By 1999 the central European transition economies had either regained (Poland, Slovakia, Slovenia) or were close to their pre-transition GDP levels (Czech Republic, Hungary)" (26.4.2000).

However, the same report shows that the Baltic States had only reached between 60 and 80 % of their pre-transition GDP levels, with Bulgaria and Romania falling into the same range. The report concludes:

"In general the transition to a market economy has brought about turbulent changes and growing evidence of economic heterogeneity and divergence in per capita income levels in the former CPEs. At the same time there emerged subgroups of transition economies in which per capita incomes were more homogeneous. Some of them (notably central Europe during the second half of the 1990s) were also beginning to catch up on west European levels, but most of the transition economies continued to diverge from one another and to fall further behind the income levels of western Europe" (26.4.2000).

Agriculture remains an important sector for all applicant countries. Agricultural employment as a percentage of total employment is above EU average of 5.2% in all candidate countries, where the Czech Republic with 5.5%, Hungary with 7.5% and Slovakia with 8.2% record the lowest rates. Estonia records a rate just below 10% while Slovenia is just above at 11.5%.

Poland and Latvia record 19.1% and 18.8% respectively, while the Lithuanian rate reaches 21%. The Bulgarian rate reaches 25.7% and in Romania 40% are still employed in agriculture.

Unemployment continues to be a major problem in some of the candidate countries. In 1998, Latvia and Lithuania had unemployment rates above 13% while Bulgaria had the worst recorded rate at 16% (Eurostat, 1998). This is partially explained by the range of the economic activity rate, which is highest in Romania at 63.6% and lowest in Bulgaria at 50.4%. However, the rate in all applicant countries is still below the average rate in the EU at 67.5% (frontier-free Europe, 2000).

Inflation continues to be above Euroland average with the Czech Republic, Hungary and Poland having a rate above 10%<sup>54</sup>. The accession countries furthest from membership fair worst with Bulgaria recording an inflation rate of 22.3% while Romania tops the list with 59.1% (Eurostat, 1999).

In trade, the accession countries continue to have deficits. In 1998, the trade balance ranges from 56.7% in Latvia to 91.4% in the Czech Republic<sup>55</sup>. The candidate countries continue to expand their trade links with the EU but the negative balance of trade with the EU perseveres. The net inflow of Foreign Direct Investment is positive in all accession countries, yet it varies widely. Slovenia only recorded FDI of 0.8% of GDP in 1998 while Estonia had the highest rate at 10.8% (Eurostat, 1999).

Further statistics indicate a long term problem in terms of social development. As an indicative statistic, the fertility rate has collapsed in Central and Eastern Europe. A report by the UN's Economic Commission for Europe notes that:

“ The start of the transition process was everywhere accompanied by large declines in output, employment and real wages, which combined to produce a reduction in total real income from employment accruing to the household sector, a major determinant the living standards of, among others, individuals and couples in their childbearing years ... The real cost of children [therefore]

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<sup>54</sup> Czech Rep. 10.7%, Hungary 14.3%, Poland 11.8%.

<sup>55</sup> Trade balance defined as exports/imports as a %.



increased as the as the real incomes of parents fell. As a result, individuals and couples postponed, or abandoned altogether, having children, thus preventing their living standards from falling even lower" (26.4.2000).

The general problems of the transition countries are aggravated by the difficulties inherent in the process of catching up in a transition environment. For the case of China it has been noted that:

"this poverty gap between regions became more and more acute, leading to a third-world division within China itself, to a theoretical debate between proponents and opponents of the 'staggered' reform theory, and to increasing concern about the importance of importance of economic development in backward regions" (Xiaoqiang & Nanfeng, 1991, p. 1).

To illustrate some of the key differences and similarities between the applicant countries, tables focusing on different subject areas have been constructed. The following tables indicate some key similarities while highlighting the differences between countries, illustrating that common trends are noticeable in all of the applicant countries. This conclusion will be reinforced in the remainder of this chapter. The first table focuses on political and historical similarities and differences.

**Table 3.a.5: Similarities and Differences of the Applicant Countries in the areas of Politics and Society**

Area	Similarities	Differences
Ethnic Minorities	Substantial ethnic minorities in all applicant countries.	Different types of minorities: EU (German, Greek), other CEEC, Russian and Gypsy.
Political System	Newly created democracies with basic democratic institutions.	Varying degrees of stability of political system.
Bureaucracy	Newly created bureaucracy, inexperienced administration.	Varying degrees of competence and corruption.
Immigration	Outflow of qualified labour ('brain drain') <sup>56</sup> .	Inflow from other states for some CEECs.
Political/ Constitutional Reforms	Some degree of reform, but a large degree of aggregate uncertainty.	Some countries attempted more ambitious transitions but success of reforms is variable.
Historical development	Some shared history of the Cold War and the revolutions.	Differences in historical, democratic commitment.
Population	All countries are relatively small in global terms <sup>57</sup> .	Large degree of variance between countries.
Territory	All countries are geographically close to EU member states <sup>58</sup> and have access to major waterways.	Size varies widely as well as situation within Europe and natural resources.

The situation of the applicant countries varies, yet some key similarities can be identified in the political background and current situation. In particular the scale of unprecedented political changes and the associated aggregate uncertainty are noticeably similar in the applicants' situation. This rise in uncertainty also led to changes in government in most applicant countries,

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56 Brain drain can also be understood to mean that high quality professionals in research will focus on subjects relevant for the more affluent region. Furthermore, brain drain also implies that it will be difficult to attract high quality professionals to the region in question (see for example Xiaoqiang & Nanfeng, 1991, p. 179).

57 With the possible exception of Poland.

58 With the exception of Romania, which needs another CEEC to join (Hungary or Bulgaria) to achieve direct access to the EU.

where the disillusioned public re-elected the communist parties which had reformed as social democratic parties.

In the economic field, the situation is similar. As discussed previously, in the initial years of transition, all countries in the East experienced large scale falls in industrial output, high rates of inflation and significant increases in unemployment, as well as social problems such as rising crime and migration. This led to an increase in individual insecurity, especially since previously these phenomena were practically unknown in the planned economies<sup>59</sup>. This also influenced public attitudes towards the transformation process, which after an initial favouring of “big bang” strategies, slowed down to a more gradual path. The uncertainty of the situation and, in particular, the long time period which was estimated for these countries to catch up with Western Europe, in terms of economic development<sup>60</sup>, also made the EU more reluctant to accept swift accession. Fast privatisation, which was initially seen as the only feasible path to reform the economy, also proved more difficult than initially envisaged. Initially large-scale give-away schemes were planned, but these soon became politically infeasible in most countries. Instead, privatisation became more gradual with most activity focusing on small and medium sized enterprises, while most large-scale enterprises remained in public ownership. The following table summarises the economic similarities and differences.

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59 Even though most of these did exist under communist regimes, usually these problems were hidden by state intervention. Hidden unemployment and inflation are disastrous for a country's economy in the long run but in the short run individuals of these systems had less to fear. Additionally, phenomena like crime and migration increased many times in the beginning of the transition period.

60 Using for example the estimates of Fischer, Sahay and Véigh in Table 10 of their paper which estimates an average of 30-62 years until GDP converges to EU levels.

**Table 3.a.6: Similarities and Differences of the Applicant Countries in their economic position.**

Area	Similarities	Differences
GDP	All countries have a low aggregate GDP. Large fall in GDP after transition.	Large degree of variance between countries. Growth varies widely.
GDP/capita	All countries have a lower GDP/capita than any other EU member state.	Large degree of variance between countries. Growth rates vary widely.
Agriculture	Large proportion of workforce in agriculture/primary products.	Percentage varies; efficiency of agriculture varies widely.
Industry	Large, often uncompetitive heavy industry. Relatively undiversified economies. Large decline in industrial output after transition.	Different outcomes of efficiency drives and creating new, private industries. Recovery of industry differs between countries.
Services	Relatively underdeveloped services.	Some countries are developing a service industry in tourism and financial services.
Privatisation	Large degree of firms privatised.	Different methods and success rates for privatisation.
Financial Sector	Relatively underdeveloped banking sector, inexperienced in commercial lending.	Different degree of privatisation and progress in developing an adequate financial system
Trade	EU largest trading partner, some restrictions on trade.	Different degrees of EU trade penetration, outside trading connections, different balance of accounts.
Macroeconomic stability	Conscious attempts at controlling macroeconomic conditions (especially inflation).	Varying degrees of success in controlling macroeconomic conditions.

The most extensive changes taking place within the CEECs involved the macroeconomic structure of the transition countries. The desire to create a market economy required a large degree of reform. The most important areas of reform for all of the applicant countries included:

- Price liberalisation

- Privatisation and the introduction of hard budget constraints for the remaining state owned enterprises
- Trade liberalisation and encouraging exports without a large increase in imports
- Creation of credit markets and reform of the financial sector
- Reduction of the state sector and the introduction of budget and national debt control
- Introducing environmental reforms
- Increasing private consumption and the standard of living while increasing savings
- Increasing GDP and the long term growth rate
- Creating conditions to encourage investment, both internally and FDI
- Labour market reform, including managing unemployment
- Macroeconomic stabilisation, including inflation and exchange rate control
- Reducing the dependence on heavy industry and agriculture
- Reform of the tax and the social security system
- Reform of the legal and administrative system, including competition laws

These reforms were not only far-reaching; they were often pursuing contradictory objectives. Furthermore, there was no agreed way forward. The sheer scale of reforms created a situation, which was qualitatively different from anything attempted before. The scope of this thesis makes it impossible to discuss these reforms in detail. It is sufficient to give a general picture of which countries chose the 'Big Bang' reform path and which decided to pursue a more gradual strategy. The discussion will commence with the Visegrad countries, followed by Slovenia and the Baltic States and concluding with the Balkan countries. The discussion will not only explore the economic reform process, but also political developments. It will be demonstrated that

the economic development is inextricably linked to political developments in the accession countries. The following discussion draws on "Eastern Europe and the Commonwealth of Independent States", published by Europa Publications (1999), as well as contemporary media sources.

The Czech Republic and Slovakia started the transition process within the Czechoslovak Federation<sup>61</sup>. They were initially seen as the model transition economy with the best chance to join the EU quickly. Czechoslovakia had inherited one of the most rigid planned economies and a restrictive system imposed after the Prague Spring. However, Czechoslovakia started the transition process with some key advantages. Firstly, the state inherited a relatively low national debt from the communist period. The economy of Czechoslovakia was also developed by Eastern bloc standards. Czechoslovakia had been one of the manufacturing centres of the East and the percentage of agricultural employment was below Eastern average. Finally, the leadership in the post-transition period was strong and consensus oriented towards Western integration.

The main political influence after transition was the Open Forum, formed as an opposition to the Communist Party. The Open Forum, which took power after the 1989 revolution, split in 1991. The centre-right wing became the Civic Democratic Party (CDP), which won the 1992 and 1996 elections under Vaclav Klaus. In the 1996 election, Klaus was obliged to form a minority government with the support of the Czech Social Democratic Party (CSDP). The situation was reversed in 1998, when the CSDP formed a minority government under the influence of corruption scandals and problems of the currency.

The transition period started on a positive note. Klaus introduced a large-scale privatisation programme early on. The programme included large-scale restitution of assets confiscated by the Communists after the Second World War. Furthermore, leases on small shops were auctioned to open up opportunities for small-scale entrepreneurship. Another change was

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<sup>61</sup> The Czechoslovak Federation split into the Czech Republic and Slovakia on 1.1.1993.



the removal of restrictions, leading to the creation of a self-employed sector. Finally, the most visible and significant part of the privatisation programme was the privatisation of the large state-owned enterprises. The Czechoslovak State (soon to become the Czech State after the 1993 split of the Federation) chose a programme of voucher privatisation. Under the scheme, each citizen was issued with vouchers, which could be used to bid for shares in companies. The depositories for these vouchers were 220 investment funds, which acted as major shareholders in the privatised enterprises, yet they were not allowed to hold more than 20% in each firm. The method, which was chosen, was gradual. Privatisation occurred in 2 main phases lasting until 1995, with over 70% of firms being privatised. Despite having a slow start in FDI, the Czech Republic soon attracted major investments, particularly from Germany. The privatisation and inflow of FDI was accompanied by the development of a commercial banking sector, attracting significant foreign ownership. The foreign-owned banks started to outperform the domestic banks, mainly due to under-performing loans. But, in general, the privatisation programme and the economic reforms introduced were a political and an economic success. This was coupled with a successful programme of opening up the economy to foreign trade, including the signature of the Central European Free Trade Association (CEFTA). This so-called Visegrad agreement was concluded by Czechoslovakia, Hungary and Poland, with Slovakia becoming a member in its own right after the dissolution of Czechoslovakia. Yet in 1997 and 1998 crisis hit the Czech Republic, moving the prospective first accession country to the last place in the first wave. The crisis will be discussed later, when the constraints of the accession process are discussed in the final chapter of this thesis.

Slovakia did not share the same history, despite having the same notional starting point. From early 1990 onwards, Slovakian independence started asserting itself. Vladimir Meciar, leading the transition period in the Slovak part of the federation, became the focal point of this movement. He was elected in 1992 with the party he formed, the Movement for Democratic

Slovakia (MDS). He was the main driving force of separation, leading to the peaceful dissolution of the Czech and Slovak Federation on the 1<sup>st</sup> of January 1993. The new Slovak state faced political upheaval early on. Splits in the ruling party led to elections in 1994, but Meciar emerged again as the main political actor. From the period 1994 till the end of 1998, Meciar and his ruling party became increasingly autocratic, leading to internal conflicts as well as a distinct alienation from the West. Slovakia became the only country to fail the political criterion of the EU and, internally, the MDS managed to block the election of a new president. Meciar assumed the powers of the presidency, in addition to his Prime Minister's powers. Despite becoming the largest party in the 1998 election, a broad coalition replaced the MDS government and finally brought Slovakia back on track for EU membership.

The independent Slovakia inherited a very different situation than the Czech Republic. Slovakia traditionally had a lower standard of living and most of the Czechoslovakian heavy industry was concentrated in Slovakia with the associated environmental problems. Yet the Meciar regime also inherited the low level of debt and privatisation under the voucher scheme, which had already completed the first phase. The second phase was scheduled soon after independence but Meciar first suspended and then scrapped the second phase. The already purchased vouchers were converted into a form of government bonds and privatisation was mainly pursued by selling shares directly to management and employees. The state also retained control over a number of major firms, including utilities and steelworks. As a consequence, the privatisation programme was deeply unpopular and was even ruled unconstitutional by the Constitutional Court.

The uncertainty and unpredictability of government behaviour also meant that foreign investors were reluctant to invest in Slovakia, with the consequence of a low relative level of FDI being channelled into the economy. Yet the Slovakian economy surprised onlookers. After an initial slump, FDI picked up and the economy started to stabilise. Remarkably, inflation was kept under control, GDP continued to grow and unemployment stabilised.

Yet the internal problems also meant that Slovakia was further behind the other Visegrad countries in their orientation towards the West. Slovakia failed to join the OECD and was delegated to the second wave in the accession process. Only the removal of the Meciar government has re-opened prospects for Slovakia and the subsequent arrest of Meciar for corruption might be the final line being drawn under this period of Slovakian history.

Hungary, on the other hand, began the transition process from a favourable starting point. Hungary had been introducing reforms for a number of years and the political elite was instrumental in the change from a communist regime to a democracy. Hungary had opened the border to Austria in 1989, introducing the first break into the iron curtain. The relationship with the USSR was swiftly dissolved and the free elections of 1990 produced a majority coalition of the main opposition party, the Hungarian Democratic Forum (HDF) in coalition with the Independent Smallholders Party and the Christian Democratic People's Party. Yet, in the May 1994 elections, the former communists, the Hungarian Socialist Party (HSP), staged a comeback, winning a clear majority. In 1998, elections produced yet another government under the Federation of Young Democrats-Hungarian Civic Party (FYD-HCP). Interestingly, economic policies remained remarkably consistent throughout the political changes with steady orientation towards NATO and the European Union.

However, the method of introducing reforms varied between the different governments. Hungary chose initially not to pursue a course of 'shock therapy' and went along a gradual reform path, which was criticised widely. Additionally, Hungary had inherited an antiquated industrial structure and high government debt. In response, the HDF government introduced a four-year plan, which included plans for the acceleration of privatisation, inflation control and the free convertibility of the Hungarian currency, the Forint. The initial effect of the programme was a fall of real GDP and an associated rise in unemployment. Inflation stayed close to or above 20% until 1994 and the budget deficit was far in excess of the level set by the

EU. As a consequence Hungary, which was seen as one of the first accession countries, fell behind the other first wave applicants.

The new socialist government, elected in 1994, was forced to introduce an austerity programme to control the spiralling trade deficit and the large budget deficit. The austerity programme stabilised the economy but at the cost of a further fall in GDP. Yet privatisation was a success. The Hungarian government had decided to sell firms' assets directly and the resulting revenues contributed significantly to the control of the budget deficit and the reduction of public debt. But the electoral backlash of not increasing the standard of living sufficiently resulted in yet another change of government in 1998.

The new Hungarian government was not uncontroversial, yet was able to reap the benefits of previous economic policies. GDP growth improved and unemployment remained stable. As a consequence Hungary could pursue a close relationship with the EU and by the early 21<sup>st</sup> century Hungary has established itself once again, as one of the front-runners for accession, having already joined NATO in 1999.

The final country, which was part of the initial three Visegrad countries, was Poland. As the largest of the applicant countries, Poland faced numerous problems in the transition period. It started the transition period as an undisputed champion of change. Solidarnosc, the former trade union, had become a democratic party and swept the board in the initial elections. Poland opted for a presidential democracy and Lech Walesa was duly elected as president in December 1990. Yet the first post-communist government resigned, as the premier Mazowiecki was beaten into third place by a maverick candidate in the presidential race. The government was replaced by a coalition under Bielecki and the broad Solidarnosc group began to disintegrate with the formation of the Democratic Union (UD). The political uncertainty was not resolved by the Senate elections in 1991, where the UD became the largest party with just over 12% of votes and a low electoral turnout. In 1992, the Bielecki government was forced to resign after a vote of

no confidence and the former communists, represented by the Democratic Left Alliance (SDL) and the Polish Peasant Party (PL) won the majority of seats. This heralded a period of confrontation between the parliament, the Sejm, and President Walesa. This confrontation was only resolved by Walesa's defeat in the 1995 election and Kwasniewski became the new President. In 1997, a broad coalition called the Solidarity Election Action (AWS) became the strongest party and formed a coalition government with the Freedom Union.

Yet the present government has also not had a smooth governing period. A part of the AWS split to form the Social Movement of Solidarity Election Action and a number of Sejm delegates left the party in protest of, firstly, the sale of the Gdansk shipyard (the birthplace of the Solidarnosc movement) and later, the hardships caused by economic reform. The government finally split in 2000 with new coalition talks being conducted currently.

Poland pursued a 'Big Bang' strategy from early on and despite the changes in government the successive governments remained committed to this strategy, albeit with varying degrees of enthusiasm. Poland started early on with a radical reform package, sanctioned by the International Monetary Fund (IMF). The programme involved liberalisation of trade, encouragement of the private sector, reductions of subsidies and defence spending, a balanced budget policy and the maintenance of strict monetary policy goals. The Polish currency, the Zloty, was partially liberalised and pegged against the dollar. Initially, these measures led to a deep recession, yet from 1992 the economy started to recover.

Privatisation was an important element of restructuring, though Poland's privatisation was essentially different to the large-scale sell-off programmes pursued in the other Visegrad countries. The main impetus of reform came initially from the growth of small and medium sized private businesses, the so-called 'de novo' enterprises. Poland also chose to pursue privatisation by a voucher scheme, akin to Czechoslovakia. But in contrast, it

took until 1995 to initiate the mass scale voucher programme and the large industrial, financial and infrastructure companies were only broken up under the centre right regime, elected in 1997. Poland's development changed substantially with this election. While initially FDI was relatively low and trade was mainly with the other CEFTA countries, after 1998 investor confidence and the opening of trade made Poland an attractive place for Western businesses. The banking sector remains underdeveloped but there are already Western banks moving in and buying up substantial shareholdings. The prospects for Poland are good at the moment. Domestic and international confidence is high and EU membership is expected soon. Yet major problems remain, including the large agricultural sector and a substantial part of the workforce able and willing to move West, for better paid employment.

Slovenia has been another success story of transition. After the brief conflict with Serbia, following the declaration of independence in 1991, Slovenia established itself as an independent entity with the help of the EU. First free elections were held in 1992 resulting in a broad coalition led by Janez Drnovsek and his Liberal Democratic Party (LDP). The main problem of Slovenia in her relations with the EU centred on the issue of compensation to Italians, whose property was confiscated in 1947 after some Italian territory became part of Slovenia. This issue was not resolved until 1996, when a compromise was found. The LDP had managed to consolidate power in the intervening years and in November 1996 was re-elected with a larger majority. Yet the coalition gained only 45 seats, opposed by a broad opposition alliance which gained the same number of seats. Only in 1997 did Drnovsek gain a sufficient majority with one deputy of the opposition becoming an independent. Yet the government has remained stable since then, not least because of the influence of the President, Kucan. Despite his relatively ceremonial role he has had great influence and after his initial term from 1992 to 1997, he was re-elected in 1997.



Slovenia's economy initially suffered not only from the rapid separation from Yugoslavia but also from the fall-out of the ethnic conflicts engulfing the other states in the former federation. The introduction of a new currency, the Tolar, was initially accompanied by high inflation. Yet Slovenia had also inherited a relatively developed economy with a large manufacturing industry and potential as a tourist destination. One of the major early challenges was the reform of the banking system, then dominated by political appointments. The restructuring and recapitalisation was not completed until 1997 and the banks are due to be fully privatised in the near future. Privatisation of the rest of the state owned enterprises commenced in 1992. The privatisation in Slovenia was a mixture of voucher and direct sales with a substantial component retained for compensation issues. The process only started to pick up speed in 1994 when large enterprises were being restructured and by 1997 the process was mostly complete. Slovenia has been successful in separating from the conflict, which engulfed the rest of Yugoslavia after the transformation. Even though the initial years of independence meant a reduction in GDP and conflict with the EU over property restitution, Slovenia managed to become one of the successes and a front-runner for EU membership.

The Baltic States faced a similar situation as part of a larger union. They were part of the Soviet Union and after the secession they needed to completely reform their political and economic system. But their experience in relation to the EU varied. While Estonia became one of the first wave countries, Latvia and Lithuania fell behind. Even though Latvia has caught up it is still behind the first wave, while many of Lithuania's economic challenges still need to be addressed.

Estonia started movements towards independence in 1988, when the domestic pressures lead to a declaration of sovereignty by the Estonian Supreme Soviet. Elections in 1990 produced a large majority for independence and a transition arrangement to independence was pursued. After brief conflict following the putsch in Russia, which crumbled due to public

resistance, Estonia declared full independence in 1991. Vāhi replaced the Prime Minister Savisaar in 1992 after the country experienced economic difficulties. Later in the same year the first free elections were held and the Pro Partia party gained the largest number of seats. The coalition government was formed under the leadership of Mart Laar, representing a decisive break with the Soviet past. After a period of radical economic reform the second free elections were held in 1995. The political scene consolidated and produced a majority for the Estonian Coalition Party (ECP) and the Rural Union. The former communists failed to gain a single seat, although the Russian minority was represented. Vāhi formed a coalition government, which was more left oriented, yet continued with the economic reforms started after the transition. However, political life had not settled down. The re-election of Meri as president was a long and divisive process and Vāhi resigned after being accused of abusing his office. Mart Siimann replaced him but recently Estonia was shaken by allegations of child abuse by leading members of the government, an issue that has not yet been resolved.

Despite political uncertainty, Estonia was one of the most radical and consistent reformers from the applicant countries. Initially GDP collapsed after separation from the SU. In 1992 Estonia introduced its own currency, the Kroon, which was pegged to the Deutsche Mark. The sale of state assets was swift and while early years produced strong inflationary pressure, strict monetary policy brought this problem under control. Growth picked up and so did FDI, particularly from the Scandinavian countries, which have taken on the role of guardians for the interests of the Baltic States within the EU. Estonia has been successful in transition, with the sole problem of a large dependence on foreign trade, with a large trade deficit.

Latvia was less successful in the transition period, partially because the country started the transformation process from a more difficult starting point. Latvia had a high degree of ethnic Russians, especially from the armed forces. Latvia's cautious approach to independence was greeted by an attempted coup supported by SU troops in 1991, which did not create a

decisive outcome, even though the SU-oriented communists gained control of most institutions. The coup in Moscow led to the declaration of independence in 1991 after a referendum overwhelmingly supported this move. The Latvian coup collapsed and the independent Latvia was born under the leadership of Godmanis. In 1992, the Godmanis government survived a vote of no confidence but was shaken to its core. The resignation of a number of ministers led to the establishment of the Latvian Way, a broad opposition movement. In the first free elections in 1993, the Latvian Way became the biggest party, forming a coalition with the Latvian Farmers Union (LFU) under the Prime Minister, Birkavs. The president, elected in the same year, was elected from the deputies in parliament and Guntis Ulmanis of the LFU gained the required majority. The LFU withdrew from government in 1994 but the new government was still dominated by the Latvian Way. However, after a banking crisis in 1995 the Latvian Way's share of seats more than halved in legislative elections. The resulting legislature was fragmented with several parties gaining similar shares of seats. This led to an extremely broad coalition under the independent Prime Minister, Skeles, which only excluded a party of the far right. Ulmanis was re-elected as president in 1996. Yet political uncertainty persisted, with the largest party in the government coalition, the Democratic Party Saimnieks - The Master (DPS) exerting power. Skeles resigned in 1997, only to be reinstated 9 days later. But throughout 1997 crisis persisted and various defections and new parties destabilised the political system. Krasts led the government for a while but after the withdrawal of the DPS, the government was seriously weakened. In the 1998 general elections, Skele re-emerged, when the party he had formed only half a year earlier became the largest party. Vilis Kristopans of the Latvian Way was nominated to form a new government and, again, a broad coalition was required.

Latvia's economy was negatively affected by the collapse of the SU, similar to the other Baltic States. GDP collapsed and only started to recover from the mid-1990s onwards. Latvia had inherited large-scale industries from

the Soviet era, which depended heavily on Soviet imports of minerals and energy. Consequently the Latvian government needed to break up these industries for liquidation or privatisation. But the process dragged on, partially because their dissolution threatened the stability of the economy and partially because of the lack of political will. The largest enterprises were still not privatised by 1998, even though progress had been made for the small to medium sized businesses. The banking sector presented another challenge. A banking crisis hit the country in 1994-95 when it was revealed that most commercial banks were hiding losses with insufficient capital to cover these losses. This led to the closure of a large number of banks and the situation only stabilised in 1996. Latvia, after introducing the Latvian rouble (which later became the Lat) also suffered from high inflation, even though in recent years a notable downward trend has been recorded. This positive trend is also notable for GDP and FDI, which have picked up considerably. Latvia has thus been catching up with the first wave accession countries and consequently the Latvian economy is considered to be close to joining the first wave countries.

This development is still some way off for Lithuania. Lithuania, the largest of the Baltic States, became independent after a referendum declaring independence in 1990, following moves for independence throughout the early 1990s. The coup in Moscow led to the complete severance of ties with the SU after the leaders of the putsch had ordered tanks onto the streets of Vilnius. Landsbergis, who had been instrumental in Lithuania's move to independence, was the most influential reformer in his role as *de facto* head of state. The government was led by Vagnorius and his Sajudis pro-independence party, but Abisala replaced him in 1992 after a vote of no confidence. In 1992 Sajudis lost the election to the former Communist Party, now the Lithuanian Democratic Labour Party (LDLP). Nevertheless the coalition government only included a minority of LDLP ministers under Lubys a former member of the Abisala government. In 1993 Brazauskas was elected President and Slezevicius was appointed Prime Minister. Slezevicius lasted until a banking crisis in 1995-96. In 1996 he was dismissed by an

overwhelming vote of no confidence to be replaced by Mindaugas as Prime Minister.

Lithuania had its share of economic problems after the separation from the SU. Lithuania shared the other Baltic States' experiences of sharp GDP decline, following independence. Inflation also accelerated and until the beginning of 1993 no real progress was made towards privatisation. The Lithuanian government was forced to accept the recommendations by the IMF and the World Bank and the economy started to stabilise thereafter. By the end of 1995 most business had been privatised and the macroeconomy was stabilised effectively. The service sector was starting to become more important, with a corresponding decline in agriculture and manufacturing. But serious problems remained. Lithuania has a large trade deficit and despite an increase in FDI there is still a relatively low level, over all. The main stumbling block in the country's relationship with the EU remains Lithuania's dependence on its one nuclear power station at Ignalina. The closure of this outdated and potentially unsafe plant is a pre-condition of membership, yet Lithuania balks at the cost of closing the source of over 80% of Lithuanian energy.

The final two applicant countries face even more severe problems. Romania and Bulgaria are the most remote, geographically, and they are also the furthest from accession. They commenced their transition from a much lower starting point and the commitment of the political elite towards reform has been doubtful. Furthermore, in both countries the communist nomenclatura has been instrumental in the transition process and it took almost a decade before a decisive break with the past was achieved. It is hard to overstate their relative poverty and the lack of progress. Consequently, it is difficult to envisage accession of these Balkan countries in the near future. Indeed, it can be doubted whether these countries will become members of the EU at all.

Bulgaria started transition as the staunchest supporter of the SU in Eastern Europe. Indeed Bulgaria had previously applied to join the SU and



the Bulgarian secret service was known as one arm of the KGB. Consequently, most of the political reform movement was driven initially from within the reforming Communist Party. The main opposition umbrella party, the United Democratic Front (UDF), was established in 1989 and scored its first major victory when forcing the election of their candidate for the presidency, Zheliu Zhelev, in 1990. The opposition managed to force the resignation of the Premier Lukanov to be replaced by Dimitru Popov, a non-party candidate. A new constitution was agreed in 1991 to be followed by free elections, which were won by the UDF. The UDF nominated the leader of the Green Party Filip Dimitrov and, despite internal divisions, he was elected as Prime Minister. In 1992, Zhelev was re-elected and strongly criticised the Dimitrov government. An alliance of the Bulgarian Socialist Party (BSP), the former communists, and the Muslim Movement for Rights and Freedom (MRF) managed to carry a vote of censure. A MRF candidate, Berov, became Prime Minister with a largely non-party cabinet. Problems with privatisation and foreign debt led to the resignation of the Berov government in 1994, and the refusal of co-operation by the BSP and the UDF, led to the dissolution of parliament. The BSP managed to reassert themselves strongly, winning an outright majority and formed a government under Videnov. Despite signing the Europe Agreement and applying for membership, the Bulgarian government confronted the EU on a number of issues. Most notably the government attempted to control the media and restarted one of the reactors of the Kozlodui nuclear power station, a plant earmarked for closure by the EU. In 1996 in an US-style primary, the UDF managed to defeat the incumbent president, who had grown apart from the opposition. Petar Stoyanov was nominated as presidential candidate and became president towards the end of the year. Videnov resigned as Prime Minister to be replaced by Dobrev. Dobrev, another BSP candidate did not last long. He was forced to resign by growing public dissatisfaction and new elections were scheduled. The UDF managed to gain an over-all majority in 1997, leading to a government under Ivan Kostov. This combination of a reformist government with a reformist



presidency gave new impetus to the restructuring of the economy and the relationship with the EU. Yet many problems with the economy remain and Bulgaria still has to introduce many reforms to catch up with the first wave countries.

Bulgaria had inherited a rigid planned economy from the communist era and reforms were costly. The Bulgarian economy was traditionally agriculturally led but heavy industrialisation had taken place under the communists. The internal division of the opposition and the relative strength of the BSP meant that little was achieved after the transition. But pressure led to the introduction of a privatisation and banking restructuring programme in the early 1990s. In 1991 an austerity programme designed by the IMF was introduced but political instability persisted. The immediate aftermath of the austerity programme saw inflation soar, alongside unemployment. GDP collapsed and the government relied increasingly on a budget deficit to maintain a minimum of social stability. The continuing collapse of the economy led to widespread poverty and in 1995, almost two thirds of the Bulgarian population was reported to be below the poverty line. The election of the BSP was accompanied by a short recovery but this positive development was negated by the economic policies of the BSP government, alongside a lack of international confidence.

By the end of 1995, serious problems were noticeable, when the government announced that the budget deficit would be almost 20% higher than previously estimated. Some privatisations and a rise in interest rates did not halt the slide and by mid 1996, the economy was in crisis again. Only the removal of the BSP government heralded a change in economic fortunes. The new UDF government in 1997 immediately signed up to another IMF programme, including the establishment of a new currency board with control over monetary policy. Thus by 1998, the Bulgarian economy had stabilised. Yet much ground still needs to be covered, to even reach the level of GDP pre-transition. The economy is nowhere near competitive conditions and privatisation and restructuring is not yet complete. The relationship with

the EU has remained difficult, partially due to the continuation of nuclear power production but also due to the serious weakness of the economy. The conflict of the West with Yugoslavia has added further economic problems, even though a financial compensation programme is under way and, politically, the EU has acknowledged Bulgaria's support of NATO.

Romania has also been beset by problems in the transition to a market economy. Romania went through a situation akin to civil war during the disposal of Ceaucescu. Yet the revolution was led by former apparatchiks whose main interest was in retaining power. Iliescu became the first president after the transition and Petre Roman became Prime Minister. The Council of the National Salvation Front (NSF) was formed as an umbrella grouping for the opposition, yet it contained many former communists. This was in the middle of bloody conflict, which saw the secret service, the Securitate, fighting pitched battles with protesters and the army in the streets of Bucharest and many other Romanian towns. The announcement of free elections heralded the victory of the revolution. Yet the NSF used its power to intimidate opposition parties by mobilising the miners of the Jiu Valley, a notorious instrument of government power. Despite ongoing protests by the opposition, the NSF won an overwhelming victory in 1990 and Iliescu was elected as president with 85% of the vote. The opposition protests, including an occupation of the university, were broken up violently by police and, following unrest, the Jiu miners were once again used to intimidate the opposition with at least 6 people losing their lives. Roman continued as Prime Minister, appointed by Iliescu, but opposition protests and demonstrations continued. Partial price liberalisation and privatisation led to protest by the Jiu miners, a departure from previous support of the government, and consequently the government resigned. Stolojan formed a new government including the NSF but also other parties previously in opposition. The NSF fared badly in local elections in 1992, resulting in a split, with the NSF retaining Roman as leader, while the new Democratic National Salvation Front (DNSF) was loyal to President Iliescu. In the 1992 general elections, the

DNSF won the largest number of seats, followed by the Democratic Convention of Romania (DCR), a newly formed opposition party. Iliescu was re-elected president in the second round and the DNSF formed a new government together with independent deputies under Vacaroiu. The DNSF was re-named the Party of Social Democracy of Romania (PSDR) in 1993 but political crisis persisted. The withdrawal of support by key parliamentary parties in 1994 led to the appointment of ultra-nationalists into ministerial posts. In 1995, the PSDR lost support from parts of the nationalists but in local elections it succeeded in gaining the largest number of posts amid allegations of electoral fraud. The PSDR subsequently removed the remaining nationalists from government in the run-up to the general elections. The DCR and the Movement for Change subsequently won these, leading to the second round defeat of Iliescu by Constantinescu, the DCR candidate. Ciorbea became Prime Minister, initiating wide spread economic reform. The effects of the reforms were accompanied by mass protests and resignations and reorganisation rocked the cabinet. In 1998, Ciorbea was forced to resign and was replaced by Vasile of the Democratic National Peasants Party, a part of the DCR alliance. But political uncertainty has persisted and the economic situation remains dire. The economic and political crisis, which hit Romania from 1998 onwards, is still being felt and the majority of Romanians remain desperately poor. The prospect of EU membership is far removed and it remains to be seen whether Romania will be able to transform, successfully, into a democratic society.

The political uncertainties have also had a large influence on the reform process. The first phase of the post-Ceausescu era was dominated by the NSF, later renamed the PSDR, ruling from 1990 to 1996. In this period reforms were gradual and little was achieved in bringing the economy into line with other applicant countries. In the second phase, the DCR, a mostly centre-right alliance, initiated far more radical reforms in the period from 1996 onwards. It has, however, to be noted that all Romanian governments struggled to maintain a political constituency for reforms and one notable

feature of the transition has been the repeated internal conflict with the miners of the Jiu Valley. Privatisation has proceeded slowly and has only been pursued consistently since 1996. Most production was still concentrated in state owned businesses until then and privatisation has still not been completed. Macroeconomic stabilisation has proved to be difficult, with inflation being hard to control and the Romanian currency, the Lei, has consequently declined significantly in value. Romania has had little success in implementing austerity measures; partially because of the protest accompanying any such moves but partially because of a lack of political will. Furthermore, Romania has been a source of migration since the transition. The groups of emigrants have included the most educated of society, as well as various ethnic groups, notably ethnic Germans from the Timisoara region and Roma and Sinti. The Romanian economy remains in a poor state and it is unlikely that notable progress will be made in the near future. Some of the economic and political problems will be discussed in more detail in Chapter 5, showing how much still needs to be done to overcome the constraints standing in the way of EU membership.

It is clear from the preceding discussion that the experience of transition has varied widely from country to country. One argument which has been widely put forward is that those countries which pursued a 'Big Bang' reform path have been most successful, especially Estonia and Poland. Yet it is noticeable that those countries which had most problems in pursuing a speedy transition have been the countries which started from the most disadvantaged positions, like Bulgaria and Romania. The most notable exceptions are Slovakia, which was led into isolation by the Meciar government, and Estonia, which became one of the first wave countries, despite being one of the former Soviet Republics. Yet, in general terms, those countries, which started the accession process from a more favourable starting point, have been the more successful countries. The countries on the Balkan fringes of Europe, in particular Bulgaria and Romania (but also those who have not yet applied to the EU like Albania, Bosnia-Herzegovina, Croatia and

Macedonia) are far from EU membership. The historical starting point has been more deterministic for the applicant countries than initially anticipated and the transformation has proven to be more difficult than expected. The relationships between the accession countries and the EU have also not fulfilled high initial expectations. The high hope of speedy membership for most countries has not materialised and for those countries furthest away, EU integration remains a distant aspiration. The relationship of the accession countries with the EU is examined in more detail in the next section.

### **Chapter 3: Reforms and the West**

#### **b) Relationship with the European Union**

After the transformation which took place in Central and Eastern Europe at the end of the 1980s and the beginning of the 1990s there were high hopes for the swift accession of these countries to Western organisations. In particular, in the Visegrad countries there were hopes to join the North Atlantic Treaty Organisation (NATO) and the European Union (EU) within a few years. The Baltic States, Slovenia and the Balkan applicants soon joined the Visegrad countries and expectations were high. But this perceived "window of opportunity" closed almost as fast as it appeared. NATO membership was initially blocked by the influence of, first, the Soviet Union and, after its disintegration, by Russia. Prospective membership of the EU was also more difficult than first perceived. The economies of the East were practically bankrupt and Western Europe was struggling with recession and internal disagreements.

The impetus of enlargement has led to the recognition that the EU has to reform internally to be able to accommodate enlargement (See for example Verheugen, 15.2.2000). The Inter-Governmental Conference (IGC) to discuss these changes has started in 2000. Yet progress is far from smooth. The changes to be decided upon are far-reaching and complex. They include negotiations on a Charter of Fundamental Rights, but also more immediate practical matters need to be decided. They include the reform of the CAP, as well as reforming the European Structural Funds. Furthermore, fundamental institutional reform has to be agreed upon. These reforms include the increased usage of Qualified Majority Voting (QMV) in the Council, as well as the reform of voting in the Council itself. The reforms started in the Amsterdam Treaty have to be concluded, including the reform of the European Parliament (EP), and the size of the Commission will need to be controlled. The current intention is that the IGC will lead to an agreement culminating in a Treaty of Nice during the French presidency in the second



half of 2000. Yet doubts have been voiced whether the IGC will produce any substantial progress (Palmer, 2000, p. 1). The institutional challenges the EU faces are summarised by the Foreign and Commonwealth Office:

“Following the conclusions of the June European Council in Cologne, Helsinki confirmed that an Inter-governmental Conference (IGC) would be convened in February 2000 to resolve the institutional issues that need to be settled before enlargement. It will focus on three main subjects:

- The size and composition of the Commission;
- The weighting of votes in the Council; and
- The possible extension of qualified majority voting.

Provision was made for the inclusion of a few related and additional items. But they too should be in the context of enlargement and reform. The Conference should be completed and the necessary amendments agreed upon by the end of 2000” (Her Majesty’s Government, June 2000).

The timetable is tight, especially in the context of previous EU reforms. The deadline for the agreement of reform has been set as the end of 2000 to ensure that the changes can be ratified by the end of 2002:

“And last, but not least, to pave the way for enlargement, Member States made the political pledge to complete the necessary reforms of the EU institutions, including ratification by the national parliaments, by the end of the year 2002” (Verheugen, 12.5.2000).

But even the member of the Commission responsible for enlargement, Verheugen, warns of the consequences if the internal reform process fails:

“It is essential that the target dates set at Helsinki for the completion of institutional reform should be met. The cost of failure would be too high: the signal to the candidate countries would be catastrophic, and enlargement itself would be put at risk. It is therefore worrying that although the IGC is scheduled to be concluded by the end of this year, no significant headway has been made so far” (12.5.2000).

The IGC will need to decide on the extension of QMV. The Commission under Romano Prodi is looking to expand QMV substantially to

“become the rule not the exception” (Palmer, 2000, p. 2).

This is to prevent the Council becoming unable to make decisions, yet it also entails a further transfer of sovereignty. Predictably, some member states have voiced serious objections, among them the Nordic countries and Great Britain. The introduction of more widespread QMV is linked to voting in the Council. The weight of votes, currently heavily in favour of small countries, needs to be addressed. The average size of applicants is smaller than the current countries. Yet the smaller countries are reluctant to formalise a loss of voting power. One suggestion is the introduction of a dual majority whereby a vote has to be passed by the majority of population, as well as QMV.

The size of the Commission itself also needs to be limited. It is generally agreed that the Commission should have no more than the current 20 members, not the possible 35 the current rules would imply<sup>62</sup>. The larger memberstates have agreed to give up their second Commissioner, yet they

“have also made it clear that they will only give up their second Commissioner if votes in the Council of Ministers are reweighted to reflect population size more closely” (European Voice, 30.3.2000).

Even this proposal could still mean a Commission of 28 Commissioners. A current proposal entails a Commission with senior and junior members, as the smaller states are reluctant to give up the right to have a Commissioner.

The smaller countries are also set to lose influence in the EP. The Treaty of Amsterdam limits the EP to 700 MEPs. Currently no mechanism has been proposed to achieve this. The representation in the EP is also heavily in favour of small countries, yet for some of the smaller countries the reduction in MEPs could entail a problem of democratic representation. This representation has also been raised in relation to the Commission. Some voices have argued that the European electorate should elect, directly, the

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<sup>62</sup> 28 countries with 1 Commissioner + 7 additional Commissioners from the larger member states (Germany, Turkey, Italy, GB, France, Spain and Poland).

Commission President. It is unlikely that this proposal will even be discussed at the IGC.

The CAP presents a major budgetary problem. Given that most CEECs have a substantial population still dependent upon agriculture, the attempt to reform the CAP is crucial. The CAP consumes about half of the EU budget and still relies, in part, on providing price support for farmers:

“The continued existence of compensation payments (albeit at levels less than 100% of full compensation for the price cuts) also raises doubts over the ability of the CAP to be extended unaltered to Cyprus and the countries of Central and Eastern Europe who are moving towards EU accession, given the implications this would have for the EU budget” (Ackrill, 1999, p.21).

Agenda 2000 and the Berlin Summit in 1999 attempted to reform the CAP but it did not go far enough. This may have been caused, in part, by protests of farmers and the EU’s farmers’ lobby.

“Although the budget constraint was intended to force significant reform, the actual outcome was a reform that can, at best, be described as minimal both in depth and breadth” (Ackrill, 1999, p. 1).

The question of agricultural reform will need to be addressed before the largest applicant country, Poland, joins. Poland still has a farming population of over 4 million and would require significant payments from the CAP. However, the poorest applicant countries, Bulgaria and Romania, add to the problem with a farming population of over 1 million and 5 million respectively. The question of how to deal with this issue has not yet been addressed and it is unlikely that a quick solution will be found. Official negotiation on agriculture starts in June 2000 with the 5 first wave countries.

European Structural Funds (ESF) reform poses further problems. Agenda 2000 aimed to address the need to cut ESF spending for the current member states to free funds for the Eastern enlargements. Yet even within the EU disputes were prevalent. The main contention was between net recipients and net receivers:

“The richer members of the EU, led by Germany, have been pressing hard for a reduction of their net contribution, while the poorer ones have tried to preserve their positive balances” (de la Fuente & Doménech, p.13, 1999).

This has led to a limitation of reform of the structural funds. Under current eligibility rules, to have a GDP below 75% of EU average, all applicant countries would receive full Objective 1 status. Objective 1, funded mainly under the European Regional Development Fund (ERDF), is the most generous of the European Funds. Without some limitations on eligibility the amount of money available for the EU budget, currently fixed at a maximum of 1.27% of EU GDP, would have to be increased substantially. A limitation of eligibility could be seen as providing second class membership to the applicants, but as yet resistance to an extension of the budget remains strong.

There have been a number of estimates of the size of the budgetary consequences. Baldwin, Francois and Portes estimate that the first wave countries will be net recipients of EU funds of about 6.8 bn ECU, with Poland receiving the largest transfer of 1.9 bn ECU. The Second Wave countries would receive 7.9 bn ECU, with Romania receiving a net transfer of 2.6 bn ECU (1997).

There are further problems, which will be exacerbated by Eastern enlargement. The free mobility of labour, guaranteed by the Treaties, will not easily extend to the CEECs. The cross border flows of workers, already experienced in the border regions of places like Germany and Austria, has been politically difficult to manage. The pressure of low-income workers attempting to find a better life in the richer West will pose serious problems. A theoretical paper by Hans-Werner Sinn predicts that the migration flow would increase after enlargement with reversal occurring later (Sinn, 1999). The question of migration has led to a study being commissioned by the EU, which concluded that the EU could expect 335,000 migrant workers from the East (Sueddeutsche Zeitung online, 24.5.2000). The fear of this widespread migration has, according to recent reports, led to Germany being unwilling to

sign the free movement provision for the applicant countries without a long term transition period (The Scotsman, 24.5.2000). Consequently, the enthusiasm in the EU for Eastern enlargement, despite contrary reassurances, has noticeably dampened:

“For the truth about the European Union is that, in its principle projects, the biggest of which is enlargement, the lack of enthusiasm for making progress - or, indeed for doing almost anything - is far from deafening than this latest flurry of ministerial speeches” (The Economist, 20.5.2000).

External economic relationships focused on the attempts of the applicant countries to create an environment of free trade, even though this enthusiasm soon faltered, not least because of the reluctant reaction of Western Europe. But the predominant issue for the applicant countries was the eventual membership of NATO and the EU. NATO created the “Partnership for Peace”, and later admitted the front-runners, the Czech Republic, Hungary and Poland. But the EU had problems coming to terms with the new political geography. Even though the memberstates and institutions expressed the wish to accommodate the countries of Central and Eastern Europe (CEE), they nevertheless stalled from devising a binding timetable.

The countries of CEE were initially enthusiastic to join the EU as fast as possible. There was overwhelming public and governmental support for membership, which was demonstrated by the official application of some of these countries to join the EU very early on. This support did become less pronounced as former communists returned to power, but the commitment of the applicant countries to Western Europe was not questioned after the changes in leadership. Public support has been relatively stable, though it has been falling slightly, as can be seen in the March 1996 Eurobarometer (Central and Eastern Eurobarometer, March 1996). The percentage of people in Eastern Europe who would vote for EU membership in a referendum is still well above 70% in all Europe Agreement countries, with an average of 90% for

membership and only 10% against<sup>63</sup>. This large-scale support has, however, been met with falling support for early membership within the political system of these countries.

As the economic situation in Eastern Europe deteriorated and the political situation became increasingly unstable, so the enthusiasm of the countries of the EU became less noticeable. The West, struggling with a recession, had to complete the Single Market in time and give the then European Community a new direction with the Maastricht Treaty. Additionally, there was internal disagreement about the future of the European Union, which focused upon the perceived impossibility to deepen and widen, simultaneously, the integration process. This problem was aggregated by the institutional problems of the EU, which could only worsen with further integration. This was perceived as especially problematic in the areas of qualified majority voting (QMV) and in the additional languages Eastern Europe would bring. Budget considerations also emerged, as first estimates showed that neither the Common Agricultural Policy (CAP) nor the structural funds could cope with Eastern enlargement without increasing the budget of the EU<sup>64</sup> or reforming EU spending policies.

Furthermore, the political situation changed radically. The fear of widespread ethnic conflict was sparked by the civil war in former Yugoslavia, in the early to mid 1990s, as well as a number of conflicts in the former states of the Soviet Union (for example the civil war in Georgia and the conflict of Aserbajdschan and Armenia over Nagorny-Karabach). This made Western organisations more reluctant to commit themselves in Central and Eastern Europe, especially as the EU, and its defence organisation the Western European Union (WEU), did not seem ready to cope with such problems.

Thus the EU created some limited aid programs, like the PHARE program, and otherwise focused its attention on the area of trade. Here, the

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63 Using the graph Referendum on EU Membership on page 59 of the Eurobarometer (Commission, 1996).

64 For a comprehensive summary of budgetary issues see von Hagen and Kumar in their section B 2; Budgetary issues (1996).



so-called Europe Agreements were negotiated in 1991 with most of the countries of Eastern Europe. These agreements are generally perceived as being neither very extensive in scope (as they focus almost entirely on trade), nor are they very liberal, where free trade is concerned. In particular there are restrictions for access of Eastern European goods to the Common Market. These restrictions concern so-called 'sensitive products', which reflect the fear of Western Europe to be swamped with cheap wage goods, produced with low environmental standards and distorted input prices. But they might also reflect the producer's interests in some areas. In this, the EU has continued a one-sided negotiation process, which has been applied to previous applicants:

"So far, the EU has endeavoured to retain the elements of the classical method of enlargement in its approach to the CEECs. Once geopolitical factors allowed, the CEECs were granted limited forms of association leading to freer trade, though with major exceptions for sensitive products. This suggests that the asymmetric characteristics of previous association agreements has not changed significantly" (Preston, 1997, p. 209).

These restrictions are crucial as they concern mainly those products where applicant countries have an extensive industry due to the allocation of production facilities within the COMECON. There is also some scope for 'managed trade', i.e. trade restrictions, in other areas concerning competition and stability considerations. This has not stopped trade increasing quite dramatically and the restrictions might well lead to new sectors of comparative advantage emerging, based on low wage and high skill production. Foreign Direct Investment (FDI) has been more focused on those countries most advanced in terms of transition and economic development and Germany has invested most, especially in the Czech Republic, Hungary and Poland. Furthermore, the cultural and political ties have also increased, especially concerning the ties of the Visegrad countries with Germany. There has been a dramatic increase in tourism, as well as some small scale cross border trade and employment.

The EU has committed itself early to the eventual membership of the Eastern European countries. This can be seen in every official paper published

by the EU. For example, the "Conclusions of the Presidency" at the Copenhagen Summit, as quoted in Baldwin, (1996), state:

"The European Council today agreed that the associated countries in Central and Eastern Europe that so desire shall become members of the European Union. Accession will take place as soon as an associated country is able to assume the obligations of membership by satisfying the economic and political conditions required."

But despite these positive commitments<sup>65</sup>, the EU has not been able to advance decisively from its initial statements of will, nor from the crucial White Paper, "Preparation of the Associated Countries of Central and Eastern Europe for integration into the internal market of the European Union" and its addendum. This sets out the will of the EU to accommodate the wish of the countries of Eastern Europe to become memberstates (in the White Paper itself) and sets out in some detail<sup>66</sup> the preparations these countries have to make to qualify for full membership (in the addendum). It does, however, lack a timetable or any real objective measuring mechanisms which would enable the countries of Eastern Europe to judge how far they have come in the quest for membership. Thus, these countries have the choice between implementing all or some of the measures the EU requires immediately, or they could introduce the measures gradually. The immediate implementation of these measures would be difficult, but would create a 'fait accompli', which would commit future governments and force the EU to react. Gradualism could possibly make the transition less painful, and thus politically more feasible, making the process of accession a more long-term objective. This clearly shows a theoretical analogy to the question these countries faced after the revolutions on whether to implement economic reforms immediately using the 'window of opportunity' ('big bang' approach) or whether to introduce them over a period of time to reduce

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<sup>65</sup> See also the Presidential Conclusions of the European Council, 9-10 December 1994 in Essen, quoted in M. Mihalka (1995) "The Bumpy Road to Western Europe", p. 79.

<sup>66</sup> To give a brief impression of the scope of the addendum, it encompasses 23 different sectors covering issues like agriculture, transport, taxation, energy and environment.

hardship ('gradualism'). The theoretical debate on this issue will be discussed in the next section.

The Central and Eastern European Countries (CEECs) face a momentous challenge in the years to come. Not only have the radical changes to their economic and political system, partially driven by accession aspirations, created a number of problems, but they also need to prepare for the accession to the European Union (EU), which almost all of these countries aim to achieve. To become a member state of the EU is a difficult process in its normal due course, but these countries also face tougher entrance criteria than any accession countries before them. In particular the Copenhagen European Council of June 1993 states that any of the CEECs could become a member only:

"if they meet the following conditions:

- Stability of institutions guaranteeing democracy, the rule of law, human rights and respect for and protection of minorities;
- The existence of a functioning market economy, as well as the ability to cope with competitive pressures and market forces within the Union;
- The ability to take on the obligations of membership, including adherence to the aims of political, monetary and economic union"

(Agenda 2000, Summary and Conclusions).

These conditions are not easy to fulfil, as shown by the Commission's rejection of half of the applicants initially<sup>67</sup>. These first wave applicant countries, which are participating in accession talks, do not fulfil these conditions completely. Rather they are seen as being able to almost meet these conditions in the medium term, as long as sustained and strong efforts are made. Thus, those countries, which started accession talks in the first wave, are not expected to join before the medium term. The Commission states for example that

"the initial round of accessions would not have any budgetary impact until about 2002-2003" (Agenda 2000, Volume I).

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<sup>67</sup> Those countries accepted for accession talks in 1998 are the Czech Republic, Estonia, Hungary, Poland and Slovenia, while Slovakia was rejected due to political criteria and Bulgaria, Latvia, Lithuania and Romania were rejected due to the economic criteria.

Accession is by no means automatic – rather, the contrary applies. The CEECs are expected to prepare themselves in a number of ways for accession. They are expected to fulfil the conditions almost completely. Most notably, they are expected to transpose most<sup>68</sup> of the *acquis communautaire*, the body of law defining the EU, before accession, which also implies having the necessary institutions as defined by the EU. This is mentioned repeatedly in the Agenda 2000. For example, it is:

"imperative that full adaptation to the *acquis* by candidate countries be realised as soon as possible. Indeed, too slow or inadequate adaptation could create serious problems after accession" (Agenda 2000, Volume II).

The full adaptation of the *acquis* is made even more complicated by the EU's continuing expansion of legal competence. This process has been linked to a continuously 'moving goal post'. The latest development has been the discussion to introduce a constitutional Treaty for the EU in the context of enlargement:

"Work is already well under way on what may become an EU bill of rights. A document called the 'Charter of Fundamental Rights' is being drafted by an ad hoc convention of assorted EU grandees ... The idea of going further, to a fully fledged constitution, appeals to visionaries who see it as a way of giving more substance to the Union (The Economist, 22.7.2000).

This extensive list of reforms is reinforced by the EU's resolve to make pre-accession aid and, indeed, accession itself conditional on the fulfilment of an accession timetable of reforms:

"From 1998, reinforcement of the pre-accession strategy will be accompanied by a move to make the granting of European Union assistance, particularly financial assistance, to the applicant countries conditional upon their implementing the programmes aimed at preparing them to meet their obligations as future Member States " (Agenda 2000, Volume II).

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<sup>68</sup> Some areas of the *acquis* are already seen as virtually impossible to fulfill and thus will probably be excluded. These include, for example, some environmental and energy directives.

Thus, applicants have to introduce a number of reforms over the next few years, while maintaining, or creating, political and economic stability. A number of reforms are needed in all the applicant countries, with some having made more progress than others. Even the Commission admits:

"Assessments of the cost of the applicant countries' adoption of the whole Community acquis ... show that it will be very considerable everywhere" (Agenda 2000, Volume II).

In fact, some doubts remain whether these costs can be covered even with the most generous outside assistance.

The adjustments will include reforming administrative systems in all applicant countries, heavy investment and restructuring in sectors such as environment, agriculture and transport, the adoption of Single Market legislation, completion of structural adjustment, and the fight against crime, while maintaining human rights.

Thus, an accession strategy must allow these countries to prepare for a later accession in an optimal way, while taking account of certain constraints. The applicants can choose to introduce all the reforms immediately (Big Bang Now, BBN), they can introduce reforms consecutively (Gradualism, GRAD) or they can choose to introduce reforms at the latest possible date (Big Bang Later, BBL). To understand the challenge the CEECs face, it is necessary to analyse closely the conditions the European Union (EU) is setting for the membership candidates. These have been stated in the Commission's document, Agenda 2000. In particular the section "Summary and conclusions of the opinions of Commission concerning the Applications for Membership to the European Union presented by the Candidates Countries" sets out the Commission's evaluation in some detail. This section discusses the ten CEECs, which applied for membership, namely Bulgaria, Estonia, Hungary, Latvia, Lithuania, Poland, the Czech Republic, Romania, Slovenia and Slovakia. Of these only five are seen as possible members in the medium term, while five are excluded from possible membership in the medium term. Even though

the five Second Wave countries have now joined the negotiation, there is still a long way to go.

The countries are judged on three criteria and an additional condition concerning administrative capability, as detailed previously. The criteria are political criteria, economic criteria and criteria on the ability to fulfil the obligations of membership. The five countries, which are judged to be closest to fulfilling the conditions laid out by the Commission, are Estonia, Hungary, Poland, the Czech Republic and Slovenia. The initial Visegrad country, Slovakia, is the only CEEC, which does not manage to fulfil the political criteria, while for Bulgaria and Romania, recent elections are seen as sufficient progress towards fulfilling the political criteria. But both Bulgaria and Romania are seen as not being able to fulfil the Economic or the Obligations of Membership Criteria in the medium term, which Slovakia is seen as fulfilling. Latvia and Lithuania are seen as not being able to fulfil, fully, the economic criteria. Lithuania is evaluated as having serious problems to achieve the necessary progress towards fulfilling the obligations of membership, which is also true to a lesser degree for Latvia. It is important to note that all of these criteria are seen as medium term goals. Thus, a country, which does not fulfil the criteria at the present moment, which applies to most reforms, is evaluated on the ability to achieve the criteria in the medium term. This makes it possible for countries to achieve membership in the medium term, as long as they put into place a sustained and major effort.

This also means that membership of those five countries mentioned as being on the right path towards membership, still need to put into place substantial reforms. Thus, membership is by no means automatic; rather it is conditional on the appropriate behaviour of countries in the mean time. This is emphasised at various points in the document. The present situation is thus only judged on whether countries are making progress towards fulfilling the criteria. This is the basis of the following table.



Table 3.b.1: Fulfilling the criteria for membership

	Political	Economic	Obligations	Admin. <sup>69</sup>
Bulgaria	Improving	No	No	No
Estonia	Yes	Yes	Yes	No
Hungary	Yes	Yes	Yes	Yes
Latvia	Yes	Partially	Partially	No
Lithuania	Yes	Partially	Partially	No
Poland	Yes	Yes	Yes	Yes
Czech Rep.	Yes	Yes	Yes	No
Romania	Improving	No	No	No
Slovenia	Yes	Yes	Yes	No
Slovakia	No	Partially <sup>70</sup>	Yes	Yes

All membership countries are judged, to differing degrees, on efforts to fulfil the administrative condition.

It is crucially important to analyse each of these criteria in turn and evaluate the reforms the CEECs must put into place before achieving their goal of membership to the EU. Each of the criteria is sub-divided into a number of areas, which are then sub-divided in broad sections concerning an area of political or economic reform. Some of these sub-divisions overlap, as they are necessary to fulfil a number of conditions. Some countries are judged to fulfil some of the conditions already, while there are many reforms where a sustained effort is deemed necessary. All of the countries are judged to have failed to reform substantially in some areas. The following tables show the scope of the reform effort and make it possible to understand the major reforms involved, even for the most advanced countries. The political criteria are summarised in Table 3.b.2.

<sup>69</sup> The ability of the administrative system to enforce the other criteria is only a condition and thus countries which fail this condition, are seen as prospective members. They do, however, need to put into place major and sustained efforts to become a member in the medium term.

<sup>70</sup> This refers to the possible introduction of restrictive price mechanisms, which is seen as a step backwards.

**Table 3.b.2: Political Criteria (P)**

Stability of institutions:
P1: guaranteeing democracy
P2: the rule of law
P3: human rights
P4: respect for and protection of minorities

The stability of institutions to guarantee certain aspects of a democratic society is also linked to the relations these countries have with their neighbours. A good or improving relationship with one's neighbours is seen as essential as these countries might well end up sharing institutions within the EU and it is of utmost importance to the EU to avoid being entangled with nationalistic disputes which are so common in Eastern Europe. The political condition is reminiscent of the criteria, which has been previously used to reject Turkey, due to doubtful democratic credentials.

This condition has, however, been extended by a criterion judging the progress these countries have made in the transition process, which also includes the ability of these countries to compete with EU economies in the medium term. These economic criteria are shown in Table 3.b.3

**Table 3.b.3 Economic Criteria (E)**

<b>E1: Functioning market economy</b>
E1a: Commitment to market-oriented policies
E1b: Privatisation of public sector
E1c: Liberalisation of prices
E1d: Liberalisation of trade
E1e: Inflation control
E1f: Legislative Framework
E1g: Land Reform
E1h: Pension/Social Security System Reform
<b>E2: Ability to cope with competitive measures and market forces within the Union in the medium term<sup>71</sup></b>
E2a: Commitment to economic transition in particular with respect to land reform, privatisation, state firms and emergence of a private sector.
E2b: Economic stability
E2c: Exporting industries
E2d: Banking and Finance Sector
E2e: Foreign Direct Investment
E2f: Trade and current account balance

Here, the different starting positions of the CEECs are becoming clear, as some countries have made considerable progress, while some only started serious reform efforts recently, notably Bulgaria and Romania. These divisions become even more pronounced when these countries are evaluated on their ability to be able to take on the obligations of membership in the medium term. Here the effort and success of countries has differed widely, which is not surprising as the Commission evaluates the countries on each and every aspect of the *acquis communautaire*, (the body of law the European Union has developed over the last 45 years), as well as their progress under the Europe Agreements. It is important to note that the Commission, on behalf of the member states, makes all these assessments. Thus, no appeal is possible. The obligations under the Europe agreement are summarised in the following table.

**Table 3.b.4: Obligations of Membership (O)**

<b>O1: Obligations set out in the Europe Agreement</b>
O1a: Right of establishment
O1b: National treatment
O1c: Free circulation of goods
O1d: Intellectual property
O1e: Public Procurement

Furthermore, there is a wide range of reforms, which the applicants must introduce in connection to the Single Market. These are summarised in the following table.

**Table 3.b.5: Obligations of Membership (O)**

<b>O2: Implementation of measures essential to the Single Market (White Paper)<sup>72</sup></b>
O2a: Free circulation of goods
O2b: Approximation of legislation
O2c: Structures to implement legislation
O2d: Restructuring of the finance sector
O2e: Company law
O2f: Accounting
O2g: Data Protection
O2h: Capital liberalisation
O2i: Public Procurement
O2j: Intellectual Property
O2k: Financial Services
O2l: Competition
O2m: Taxation

There are other parts of the *acquis*, which also need to be addressed. These are summarised in the following table.

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<sup>71</sup> Some of these measures overlap with E1, as some of the conditions for a functioning market economy are identical to conditions enabling a country to compete. If the failure of a country is stated previously it is not repeated in this section.

<sup>72</sup> Some of these measures overlap with O1, as the measures in the Europe Agreement are only the first step to O2. If a country has not managed to implement the Europe agreement in these fields, their failure in the further reaching measures in O2 is not mentioned, as it is self-evident.

**Table 3.b.6: Obligations of Membership (O)**

<b>O3: Progressive transposition of the other parts of the <i>acquis</i></b>
O3a: Education
O3b: Training and youth
O3c: Research and technological development
O3d: Fisheries
O3e: Small and medium enterprises
O3f: International trade relations
O3g: Development
O3h: Telecommunications
O3i: Audio-Visual
O3j: Taxation
O3k: Statistics
O3l: Consumer protection
O3m: Customs
O3n: Environment
O3o: Transport
O3p: Employment and Social Affairs
O3q: Regional policy
O3r: Agriculture
O3s: Energy
O3t: Border Controls
O3u: Participation in the third stage of Economic and Monetary Union
O3v: Possible Participation in the EURO area <sup>73</sup>
O3w: Justice and Home Affairs
O3x: Common Foreign and Security Policy

The massive task these countries face is generally seen by the Commission as having to take place before accession, with some exceptions. The main exception is the environmental legislation, where the Commission recognises the impossibility of achieving a comparable standard before accession. The CEECs are thus required to put one of the most ambitious and costly programs into place in the coming years. To be able to achieve this, they need a capable and efficient administration - an area in which most CEECs fall short. The administrative conditions are set out in the following table.

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<sup>73</sup> This is not a condition for membership.

**Table 3.b.7: Administrative Condition (A)**

<b>A1: Capacity of the legal system to put into effect the principles of democracy.</b>
<b>A2: Capacity of the legal system to put into effect the principles of the market economy</b>
<b>A3: Capacity of the legal system to apply and enforce the <i>acquis</i> in practice</b>
A3a: Applying the <i>acquis</i> effectively
A3b: Uniform application of Community law in the single market

It is thus clear that the CEECs face a most daunting challenge. Not only are they required to instigate far-reaching and costly reforms, they also compete with each other to be among the first to gain entrance.

The scale of reforms is staggering. The applicant countries face a process, which is as challenging as the transition they faced after the revolutions. Yet there are qualitative differences between the accession process and the transition process. Firstly, a large degree of transition has preceded the accession process and the economic criteria of membership imply a successful transition. But the accession process goes further. A country needs to introduce a number of costly reforms, which offer little or no benefit on their own. Rather, they can only be understood in the context of accession. These reforms might even be in direct contradiction with the goals of transition. Yet, they carry an important consequence. The EU sets the reforms, as pre-conditions of membership. Thus, there is no option to omit some reforms if membership is desired, driven by the perceived substantial benefits of membership. Not only do the applicant countries see membership as an important access route to Western markets, they see accession as the fulfilment of aspirations to become part of the West, once again. This would end the period of external control by Russia in the future of the CEECs, and it is seen as guaranteeing the security of these countries in an uncertain world. This is especially important in the context of the applicants' history,



characterised by the major conflicts, which have shaken the political and economic systems of Europe in the last centuries.

The problem, which has not been addressed sufficiently in past literature, is the process by which these countries can link their aspirations to the developments within Europe. In particular, it is unclear what policies are optimal in the pursuit of EU membership. Transition economic theories can be usefully applied to the accession process, yet they do not cover some of the salient features present in the race for fast EU membership. The next chapter of this thesis sets out a framework in which these questions can be addressed. In particular, it develops a model of the accession process, which addresses the questions posed by the combination of accession and transition.

## **Chapter 4: The Model**

### **a) Issue Definition**

Since the revolutions of 1989 and 1990, ten Central and Eastern European Countries have applied to join the European Union. The Commission of the EU has grouped these countries into two groups, according to their degree of readiness and preparation for full EU membership (Agenda 2000). This grouping has been reaffirmed in the progress reports, which were delivered in 1998 and 1999. The First Wave includes the Central European Countries of the Czech Republic, Hungary, Poland and Slovenia, as well as Estonia. The Second Wave contains Latvia, Lithuania and Slovakia, as well as the Balkan countries Bulgaria and Romania.

The applicant countries lag far behind the economic and political level of development of the current memberstates. Their GDP per capita is below the level of the poorest Member State, Greece, and their democratic institutions are in their infancy. The CEECs not only differ in comparison with the EU, they also differ among themselves in geographical size, population, and geographical location, including large countries like Poland and Romania, and a number of small countries like Estonia and Slovenia. The democratisation process has advanced, but Slovakia, Bulgaria and Romania still face many problems. The economic situation also differs widely. While some countries, like Hungary and Slovenia, have made a lot of progress in terms of reforms already initiated and the achievement of a stable market economy, other countries still lag behind, for example Bulgaria and Romania. Those countries lagging behind face a long, and potentially costly, accession process without the reassurance that, eventually, membership of the EU will be achieved.

The EU has maintained a close relationship with the CEECs. The Europe Agreements and the PHARE assistance programme have set a general framework, as discussed in the previous chapter. The pre-accession strategy,

which was detailed in Agenda 2000 in 1997, has been followed by the annual Progress Reports in 1998 and 1999.

The accession requirements of the European Union are substantial. The CEECs need to fulfil the so-called Copenhagen Criteria. They need a functioning democracy, including democratic institutions and respect for minority rights. There is also a need to be economically prepared for membership, which includes a functioning market economy, as well as having the ability to compete with EU competitors. The adoption of the complete *acquis communautaire* before accession is generally seen as a strict requirement:

"An important aspect of accession negotiations has always been the insistence of the existing Member States that the applicant country should accept the 'acquis' - that is, the body of laws and rules which have been developed over the years - without significant change" (Avery and Cameron, 1998, p. 32).

The Commission states that it is

"... imperative that full adaptation to the *acquis* by candidate countries be realised as soon as possible. Indeed, too slow or inadequate adaptation could create serious problems after accession" (Agenda 2000- Volume II- Communication).

The accession criteria also pre-suppose administrative structures in the applicant countries which enable the achievement of these goals.

As yet, no country fulfils these conditions. The most recent Progress Report (1999) judged Hungary to be the most advanced. Latvia might move into the First Wave and Slovakia, despite making some progress, is the only country which does not yet fulfil the political condition. This demonstrates that the *acquis* is wide reaching, complex and, in part, costly to implement.

There will be no immediate accession, but countries will join over a long time period. The first accession could possibly take place in 2003 or a little later. But for some countries this is an open-ended process, which might only be concluded by 2020:

“The major question for the future, however, remained the timespan within which the CEECs might expect accession to the EU” (Gower and Henderson in Henderson, 1999, p. 278).

The countries will not join in groups, or the announced waves, but individually or in small numbers. The nature of this process poses problems for both the EU and CEECs. As explained previously, one of the main problems, for the EU, is a distinct need for institutional reform, which should partly take place in the current year. Both the Common Agricultural Policy (CAP) and European Structural Funds (ESFs) need to be reformed to take in the CEECs, which are less developed than the current member states and have a large agricultural sector. Other problems include East-West migration, transnational pollution and trade issues which all have to be addressed before accession.

The CEECs also face major economic and political difficulties, which are the focus of this thesis. One of the main problems is that of Political Feasibility. The CEECs need to maintain a political constituency for membership in the accession process. Problems will be caused especially for governments in those applicant countries which face a long accession process and a costly readjustment.

Time Inconsistency also has to be taken into account, which describes a commitment problem. The CEECs need to commit to a certain accession process without reneging on promises of reform. The possibility to surprise the population and markets creates an incentive to go back on previous announcements which can jeopardise the accession process, especially when this lack of firm commitment becomes expected by the economic agents.

Uncertainty is a further problem in the accession process. The accession process entails a high degree of uncertainty about outcomes. This aggregate uncertainty makes decisions about timing and sequencing of reforms extremely risky and as the reforms are necessary conditions for membership uncertainty, can endanger membership itself.

The EU must choose how best to encourage accession while considering the constraints detailed above. This requires that the EU uses transfers in the best way to encourage the necessary reforms enabling accession, while the CEEC governments must choose the best strategy for the implementation of these reforms. The optimal way of preparing for accession is, however, difficult to define. Economic models can be used to examine the problems of Political Feasibility, Time Inconsistency and Uncertainty. Analysis is then applied to the CEECs present situation and a policy recommendation for the EU and the CEEC is made. Thus, the main thrust of these models is to decide the optimal way of introducing the reforms necessary for EU membership and how the EU can encourage this process.

To examine the accession process, an economic model is necessary to be able to determine the interaction of the choices the CEECs can make and the constraints they face. There is a distinct need to model a process, which includes the most important aspects of the CEEC position, as well as EU influence on this process. There are numerous models and literature concerning necessary EU reforms, which assess the size and significance of the EU problems, likely to occur after accession. Models and literature concerning the impact of membership on the CEECs also exist, as well as dealing with the general transition framework. There are, however, no economic models and only a limited amount of literature dealing with the process of accession. Economic models of transition economics can help, but they overlook some of the salient features of the accession process. The following section gives a more complete picture of the debate, which has been conducted in the field of transition economics.

Since the fall of the communist regimes of Central and Eastern Europe, policy makers and economists alike have attempted to find the optimal strategy by which to transform the planning system into a Western style market-based economy. Even though a consensus exists as far as the goal of transition is concerned, the actual method has been widely debated. This debate has led to a division in the field of transition economics with some

theorists favouring a "Big Bang" approach while others tend to favour "Gradualism". The Big Bang approach proposes to introduce the necessary reforms as soon as possible, using a "window of opportunity", while Gradualism favours the introduction of the necessary reforms distributed over a longer period.

While Western theorists and politicians have favoured the Big Bang approach, the peoples of Eastern Europe have not shared this enthusiasm. This has been demonstrated by the Eastern European electorate almost unanimously returning former communists into government after the first reforms had been introduced. A reversal of this trend is apparent in recent elections, but this process has highlighted voter dissatisfaction with the reform process faced by policy makers in the CEECs. Transition economists have thus attempted to incorporate political constraints in their analysis to ensure that transformation strategies are optimal even when political constraints have been taken into account.

Most notably, various papers by Dewatripont and Roland<sup>74</sup> highlighted these issues. They demonstrated that, under certain circumstances, Gradualism maximises economic benefits, while being politically feasible, whereas a Big Bang approach can be impossible to implement or sub-optimal. They derived their result by demonstrating that Gradualism is an optimal strategy if an option value of reversal exists. Furthermore, they stipulated that a government could use "divide-and-conquer" methods by introducing reforms over time.

To demonstrate this approach, Dewatripont and Roland (1996) use a representative agent framework, modelling the effect of a number of reforms on different sections of the population. Voters are split into three distinct groups with different reforms affecting each group differently. This split is somewhat arbitrary as one could split the voting population into any odd number of groups. However, this would not crucially change the analysis and

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<sup>74</sup> See for example Dewatripont and Roland (1991, 1996) and Roland (1994) as discussed in Chapter 1.



thus the three groups are chosen as they present the smallest possible degree of mathematical complexity. The government will only implement a reform strategy if a majority of voters supports this particular policy. This behaviour of the government is based on the government's intention to remain in power and effective lobbying by different groups in society, while altruistic motives are disregarded. Voters only support reforms, which offer a direct benefit to their group in each time period. By distributing reforms over time, the government can control the negative effects so that only a minority votes against the proposals. This minimises adverse publicity and disruption in each period and, thus, all reforms can be implemented. In this framework, the Big Bang approach is politically impossible as the majority of voters feel the adverse effects. This assumes that voters are "myopic"; they only evaluate present outcomes and not future gains or losses and no discounting takes place. If voters are fully rational, the "divide-and-conquer" approach cannot be implemented and the model thus relies entirely on a very limited view of rationality in the form of the myopic voter.

The framework set up by Dewatripont and Roland, (1996) can be adapted to incorporate the special circumstances which a country faces when preparing for membership of the European Union (EU). In this context, the reforms are synonymous with the adjustments of the economic system required by the European Union. The necessary adjustments to prepare the countries of CEE for the Single Market are set out in the White Paper ("Preparation of the Associated Countries of Eastern and Central Europe for integration into the internal market of the European Union" and "Addendum", 1995) of the Commission and cover a number of different sectors of the economy. The Copenhagen Criteria and Agenda 2000, as discussed in the previous chapter, detail further necessary reforms. These adjustments can be seen as necessary conditions for accession, but their implementation does not mean immediate accession, as membership will not be attainable for a number of years (See for Example, Baldwin, 1995, Executive Summary xvii-xviii). Thus, the process of accession can be regarded

as a specific form of transition which must take account of political constraints.

The political constraints of any given adjustment path are assessed by using a model of voting behaviour adapted from Dewatripont and Roland's "divide-and-conquer" model (1996, p. 10). This model has been extended to incorporate the notion that voters are rational and consider future scenarios. It, thus, removes the restrictions imposed by the myopic voter assumption, which assumes extreme limitations on individual rationality. Furthermore, the framework has been extended to model the problems which the CEEC governments face in relation to Time Inconsistency and Uncertainty.

The model incorporates a positive benefit from membership to society as a whole even if a minority is adversely affected. This benefit becomes partially available during the period leading up to accession, depending on the number of adjustments already implemented. The benefit to society as a whole is assumed and thus open to debate, but there seems to be a good argument that membership is beneficial to CEECs as a whole, while adversely affecting some sections of society.

As these positive benefits only transpire when all reforms are implemented, there is no option value of reversal as this removes the country from the ultimate "trophy" of membership. There also has to be a benefit for the current EU member states to ensure that the EU has an incentive to pursue enlargement. Baldwin, Francois and Portes, (1997) estimate the effect from membership as being an increase of income of 0.2% for the EU and 1.5% for the CEEC<sup>75</sup>, under a conservative estimate. Under a less conservative estimate, the CEECs gain much more with income increasing by 18.8%, mainly due to an assumed increase in investment caused by a reduction in Uncertainty. However, Rodrik warns in his discussion of the paper:

"... that the authors exaggerate the economic benefits of enlargement – wildly so in the case of the CEECs – and ignore some of its costs" (p. 170, 1997).

By introducing a positive gain from membership, the model can be used to determine an optimal strategy for the introduction of adjustment measures necessary for accession to the EU, while taking account of constraints.

The models developed thus include a number of features, which cannot be found in models of transition economies. The main assumption is that the effect of membership is positive for both the EU and the CEECs. This positive effect includes both political and economic elements. For the CEECs,

“Arguments in favour of joining the EU tend to be presented in terms of the logic of historical precedent, geographical position and psychological need. These are often reinforced by reference to expectations that membership will bring substantial economic benefits ... ” (Grabbe and Hughes in Henderson, 1999, p. 189).

This is a debatable point, but generally agreed in the literature. The EU's benefits are mainly presented in economic terms:

“On balance, enlargement should be economically beneficial for the Union because it is likely to lead to better performances ... ” (Avery and Cameron, 1998, p. 141).

The effect of reforms, however, can be positive or negative. A positive outcome might involve the macroeconomic reforms necessary for the functioning of a market economy. Negative reforms might involve the introduction of parts of EU legislation, for example, the environmental standards. Reforms will also have a distributional impact, which is crucial for the problem of Political Feasibility. In general, voters must have an overall positive effect from the accession process, where future outcomes are discounted, as they will vote against a process, which will deliver a negative outcome.

There are prior benefits from the accession process, which can be explained by trade and EU transfers. Reforms are interconnected, which means that positive or negative complementarities exist between different

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<sup>75</sup> Their model excludes the Baltic States.

reforms. As there is a benefit from introducing unanticipated changes, the problem of Time Inconsistency can be observed. This benefit comes from population adjustment to negative reforms, which are ultimately not introduced. An example might be an adjustment by firms to anticipated price liberalisation, which is then not carried out. A residual uncertainty of reforms and membership not taking place is also included in the models, which can be explained by changes in the international economy or the possible failure of internal EU reforms. As previously noted, reforms are necessary conditions to become a member of the EU, so no opt-out exists. A limited number of reforms will only be introduced prior to accession if they are beneficial for the majority of the population, as transition periods will be put into place for some sectors<sup>76</sup>. The CEECs have to choose when and in what order to introduce reforms. This means a strategy has to be chosen and sequencing will be important. Within these parameters the EU and the CEECs have certain choices.

The EU can determine some variables. These are mainly the size of transfers and whether transfers are dependent on introducing reforms by the CEECs. Even though the applicant can choose to use internal redistribution to correct effects caused by the accession process, this will be limited by the lack of public funds. The EU can choose between unconditional transfers that the applicant receives without a punishment if reforms are not introduced. Conditional transfers are tied to the success of the reform process and will be cancelled if the process falters.

The variables, which are determined by the CEECs, are related to the introduction of reforms and whether there exists a credible pre-commitment to this process. The applicant's strategy is mainly linked to the speed of introducing reforms. Under Big Bang Now (BBN), the applicant chooses to introduce all reforms as soon as logistically possible. This would involve introducing beneficial as well as costly reforms immediately. Big Bang Later

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<sup>76</sup> The most obvious sector will be environment, as the cost of introducing the environmental *acquis* will be prohibitive. Certain parts of the environmental *acquis* could also be exempted.

(BBL) on the other hand involves the introduction of all reforms as late as logistically possible, i.e. immediately prior to accession. Under Gradualism (GRAD), the applicant chooses to introduce some reforms immediately and some prior to accession but it would also involve deferring some costly reforms to the future.

A BBL approach would defer any costly payments to the future and might avoid sunk costs in the mean time, in particular, in areas where the economic policies of the EU are of doubtful economic merit for the Eastern European countries or indeed for the EU members themselves. There is, however, a problem of credibility and the applicants would be disadvantaged in the accession negotiation, given the conditions the EU has set. Countries could also miss a window of opportunity, which might make this policy costly and politically unfeasible. When considering a BBL strategy, one is struck by how far this strategy deviates from the advice given to the transition countries. A BBL strategy postpones difficult decisions to a later date in time. It is not necessary to have successful reforms to finance transfers, as there will be substantial transfers from the European Union as soon as the applicant countries become members of the EU. A problem might arise with complementarity of reforms. If one reform is a precondition for another one, it is impossible to enact all the reforms at the point in time of membership. This would mean that some of the reforms would have to be enacted during the accession negotiations.

But a problem arises with public support of a BBL strategy. Firstly, the initial enthusiasm concerning membership might diminish over time. If such a trend took place, the window of opportunity might disappear. Furthermore, long term satisfaction of Eastern Europeans might be risked if there is a BBL strategy. The first few years could prove painful, economically, if all reforms are implemented at once, despite possible transfers of the EU. This could lead to a negative image being attached to EU policies, which might be difficult to change in the long term. David Phinnemore states that:

“If CEECs are required to assume early on the more economically burdensome elements of the *acquis*, such as environmental, health and safety standards, fears of job losses could dampen enthusiasm for membership” (in Henderson, 1999, p. 78).

Expectations and reality could diverge after membership and this might not enable the creation of a solid constituency for the EU. This could mean that the chances for re-election of the government leading the country into the Union would be diminished. Thus, under a BBL strategy the commitment of governments to EU membership could be Time Inconsistent and would not be believed by the EU institutions and memberstates, the populations of Eastern Europe and the international markets. That could prove disastrous for these countries in the immediate future, as it would create a situation in which the EU would not be willing to consider seriously the Eastern enlargement. Furthermore, credibility of these countries, internationally, would be seriously challenged. This would mean that government policies, like exchange rate and price stabilisation, would become more costly and could be aggravated by the lack of investment. The BBL strategy could thus undermine political support in the long term and might make the immediate future more painful. This could even result in membership becoming postponed, indefinitely. The advantage of this approach is the availability of transfers, through the mechanisms of the EU after membership and the avoidance of costly reforms. But as membership itself becomes doubtful, this could prove to be a costly reform path.

To address radically the problem of lack of credibility, the countries of Central and Eastern Europe could introduce immediately most of the laws and mechanisms of the EU. One has to note that this Big Bang Now (BBN) strategy will not entail introducing all laws of the European Union now, as this is impossible while not being a member. In particular, transfers from the Union cannot be expected to be of a comparable scale and, thus, some of the more costly programmes, like the Common Agricultural Policy (CAP) and the



European Structural Funds, would be impossible to implement.<sup>77</sup> These transfer considerations will be particularly relevant to the discussion of “big bang” versus gradualism in the context of preparation for EU membership. Big Bang Now would use the window of opportunity given by the large-scale support for EU membership and would constrain future governments, but it might be very costly. A proponent of this approach is Messerlin as advocated in his paper “The EC and Central Europe: The missed rendezvous of 1992?”, (1993). He contrasts the possibility of the most advanced applicants joining the European Free Trade Association (EFTA) with the possibility that the Visegrad countries

“... (and other CEECs once they are ready) would simply adopt the Treaty of Rome for themselves and start exactly the same process of economic integration as did the six founder states of the EC in 1958” (p.105).

He then concludes that the adoption of the Treaty of Rome is optimal for these applicants.

Further support for a Big Bang approach comes from a paper by Dehejia and Dwyer, “Output and Unemployment Dynamics in Transition”, (2000). The paper concludes that because workers will start quitting before an announced reform,

“This can be taken as an argument against announcing a delayed reform: the losses in output implied by the endogenous cycles would be attenuated if the reform were unanticipated, i.e. announced at a given date and implemented with immediate effect” (p. 16).

It is important to note that a BBN solution would entail a variety of practical difficulties in the context of accession. Firstly, transfers between CEECs would be politically controversial, as they entail sacrificing own economic development for the potential net contributors. Structural Funds are central for the European Union, but as there are no rich countries in Eastern

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<sup>77</sup> No analysis is made of the desirability of such programmes, as the assumption here is that with eventual accession, the Visegrad countries have to accept these programmes and thus the associated costs will have to be paid at that point in time.

Europe, these funds would be impossible if not financed by the West. Some EU programmes would be difficult to implement in Eastern Europe at the moment. The CAP is an obvious example, which would be very costly and would make the relatively large agricultural sector in the applicant countries a 'black hole' for funds. Even if the CEECs have to adopt this policy with eventual accession, it would be optimal to postpone costly reforms until such a time. The institutional structure of the European Union could not be implemented immediately either. A Eastern European Court of Justice would have to refer decisions to the Court of Justice of the European Community as it would otherwise mean that the law is interpreted differently in both parts of Europe, creating difficulties when accession takes place. It is also questionable whether the countries of Eastern Europe are economically ready for the Treaty of Rome, despite offering tangible benefits from trade. There is an argument that the CEECs need to protect some industries (a slightly altered infant industry protection argument) and might need to maintain inefficient industries in a variety of sectors, to keep levels of unemployment at a low pain threshold and to maintain a political constituency for EU membership.

Gradualism, as demonstrated in the previous chapter, seems to be the approach which has been favoured up to now. Whether this is economically optimal and will continue to be economically optimal is an unresolved question. Gradualism, nevertheless, seems to be the most feasible option from a political perspective, and might be least costly. The advantage of Gradualism in the accession process is that this strategy offers the opportunity to defer some of the more costly reforms until the future. This overcomes some of the problems of the Big Bang strategies detailed above. In particular, the gradual strategy can reap benefits of reforms now, while maintaining a political constituency for reform. Furthermore, a country pursuing a gradual strategy still demonstrates progress within the accession process and thus eventual membership remains attainable.

Yet Gradualism also shares some of the disadvantages of the Big Bang Now strategy. A gradual approach can miss an important window of opportunity, as some reforms are deferred. The EU might also judge a gradual progress as being less decisive, creating the possibility for a country to fall behind in the accession process. The gradual strategy also shares some of the problems of the Big Bang Later strategy. In particular, the temptation not to introduce costly reforms despite announcing them previously can cause problems of Time Inconsistency. Furthermore, the Uncertainty associated with such a strategy could further reduce welfare.

Thus, even though the aggregate effect of membership is positive, a number of different strategies can be employed by the applicant countries to attain membership. The beneficial impact of membership occurs in the future so the population will not value it as highly as current benefits or costs. It is thus necessary to use discounting when considering the present situation. As reforms are positive as well as negative, they will affect different groups in society to different degrees. Transfers, especially of the EU can increase the benefits for all groups and thus reduce the problem of Political Feasibility.

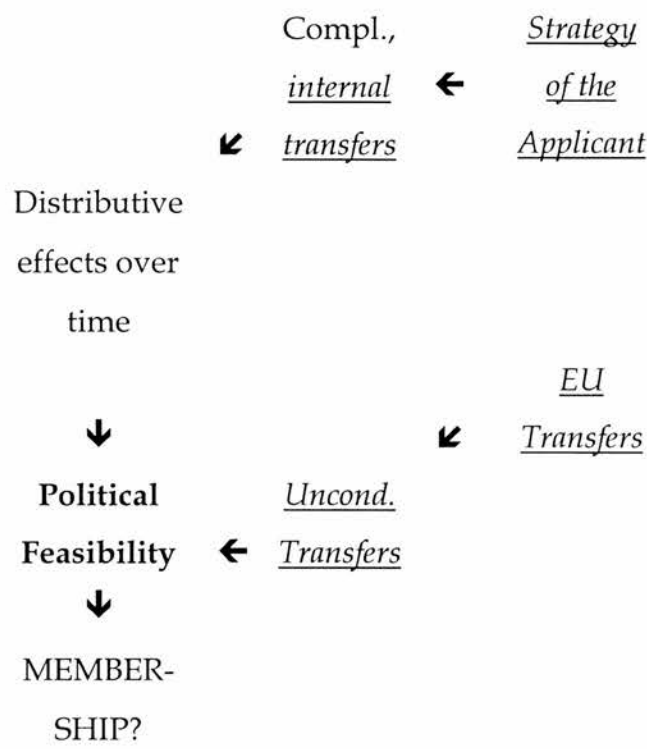
The CEEC governments cannot commit credibly to a reform programme, as any announced reform can be later cancelled. This can bring benefits to the economy if people adjusted to a negative reform and then it does not take place. Given this incentive, the people will not believe any government announcements. But as the reforms are necessary for EU membership, the population will forego the discounted benefit from membership. Because the EU can make transfers contingent upon reforms, the EU can credibly commit the applicant government to a reform programme. Thus, we need to determine which strategy might be Time Inconsistent and what size of EU transfers is necessary to credibly commit the applicant government to a reform programme.

The choices of the CEEC and the EU are made in an uncertain world and their choices will influence the likelihood of reforms and membership. Both the EU and the CEEC government have to take into account the choices

of the other to derive the best choice for themselves, but there will be a residual uncertainty neither of them can influence. The resulting probability of reforms and membership taking place will crucially depend upon whether EU transfers are conditional or unconditional on reform programmes. But the probability of reforms and membership taking place will also crucially depend upon the incentive to go back on earlier announcements of the CEEC government, potentially creating a Time Inconsistency problem.

These constraints are difficult to model. Yet they are essential to capturing the current position of the applicant countries. Furthermore, they have to be combined with the choices a CEEC government can make, in particular, with the choice of strategy. The EU's influence on this process also has to be included explicitly, particularly with respect to transfers. The increasing complexity of such a number of variables makes it necessary to model each constraint individually and to then combine the results. The models are interconnected and many of the variables and choices influencing the different constraints are the same. The best way to illustrate the relationship between the different models is through diagrams. The following diagram shows the relationship between the choice variables and political feasibility.

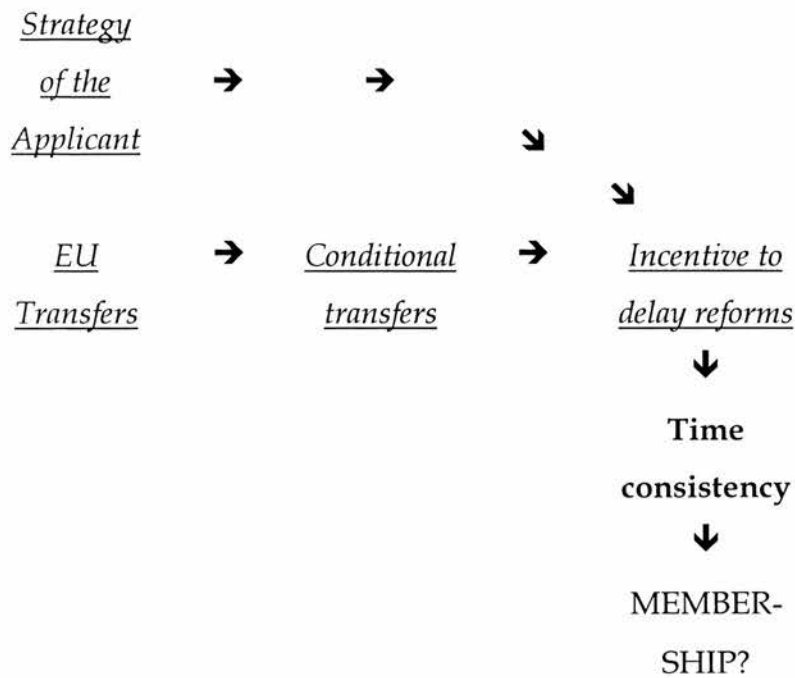
Diagram 4.a.1: Relationship between the choice variables and Political Feasibility



The reform strategy of the applicant country, as well as the level of transfers of the EU, crucially influences Political Feasibility. Furthermore, the interaction between the different reforms, i.e. their complementarity, will also affect the distribution of costs and benefits and thus Political Feasibility.

The following diagram shows a similar interaction for the time consistency constraint.

**Diagram 4.a.2: Relationship between the choice variables and Time Inconsistency**

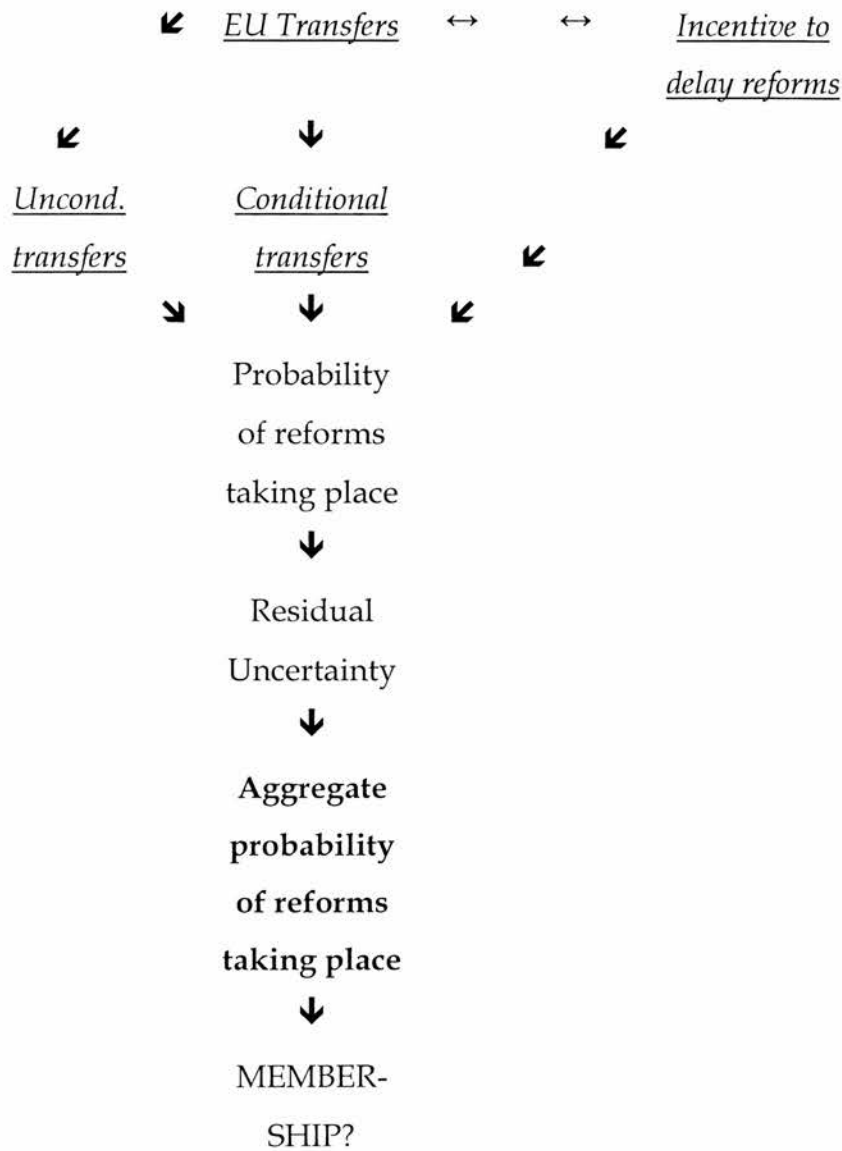


Time consistency, again, crucially depends upon the interaction between the strategy of the applicant and the transfers of the EU. Here, conditional transfers are crucial, as they can commit a government to a time consistent strategy by punishing deviation.

The following diagram shows the interaction between the choice variables and Uncertainty.



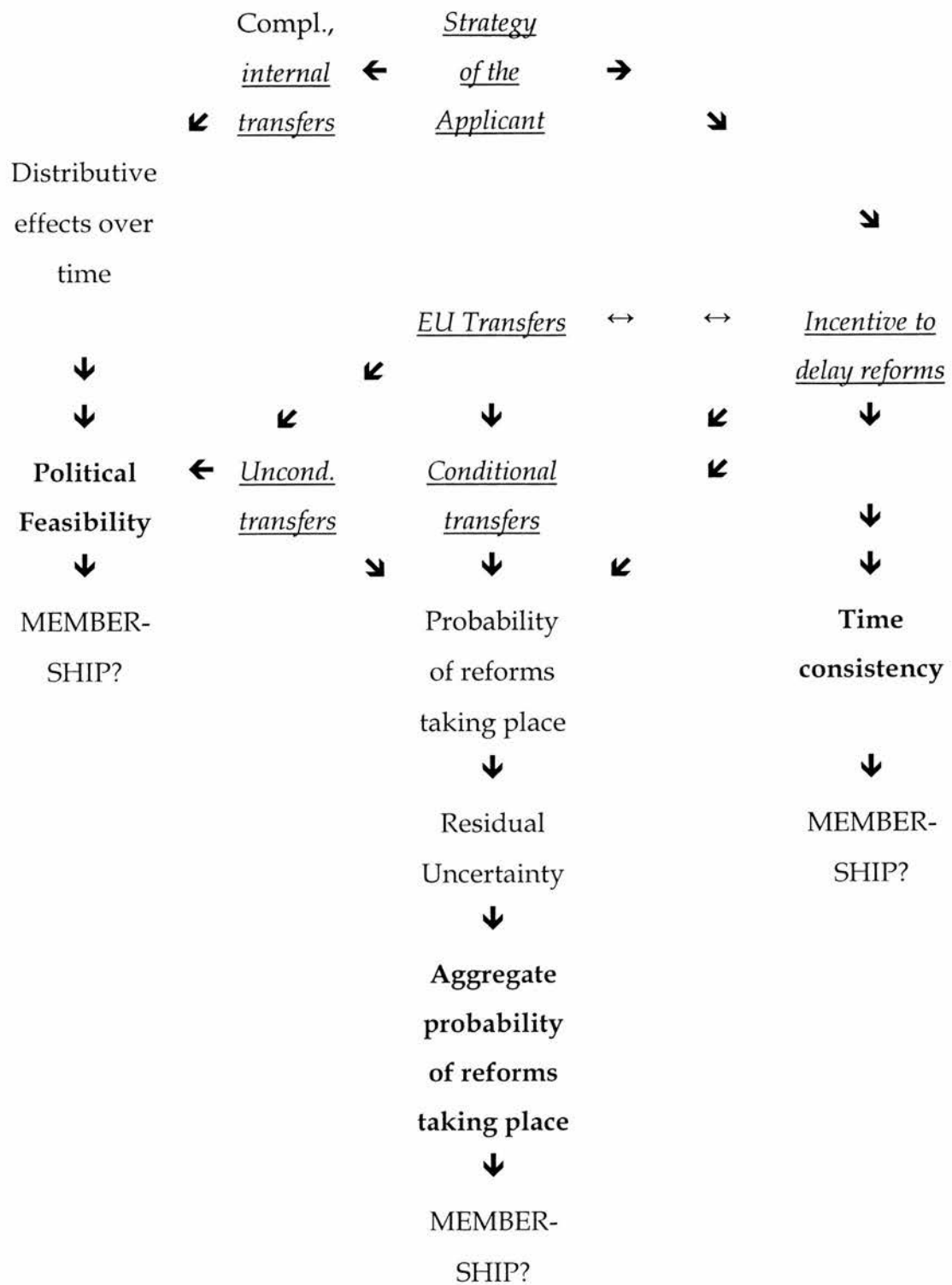
**Diagram 4.a.3: Relationship between the choice variables and Uncertainty and the conditional probability of reforms taking place**



The diagram illustrates that the probability of membership taking place depends upon the choices the EU makes, as well as a level of residual uncertainty present in the accession process.

The following diagram combines the previous diagrams to illustrate the scope of the modelling in this thesis.

Diagram 4.a.4: Relationship between the choice variables and all constraints



It is clear that all the models are interrelated and thus the results from each model can be combined to give overall results of the interaction between choice variables and the constraints.

## Chapter 4: The Model

### b) The Model

The model uses a representative agent framework adapted from the Dewatripont and Roland, (1996) "divide-and-conquer" analysis. There are three time periods, the Short Run (SR), the Long Run (LR) and Membership (M) with associated time discount factors  $d_{SR}=1$ ,  $d_{LR}$  and  $d_M$ . These discount factors take a value between 0 and 1 and a low discount factor signifies a high degree of future discounting or "impatience".

The model divides the voters into three population segments - type A, type B and type C, affected differently by different events. There are three events: Reform 1, Reform 2 and Membership. Reform 1 and Reform 2 are associated with dummy discount factors. These dummy discount factors are a modelling device to analyse benefits, which depend on the implementation of these reforms. These benefits are multiplied by the dummy discount factor, which takes a value below 1 as long as the reform is not in place and takes the value of 1 in the period after the measure is implemented. Their respective size depends on the importance of that particular reform. The reforms can also be seen as groups of reforms enacted simultaneously and having aggregate benefits or losses. In this model, the reforms are the adjustments an economy has to make to attain membership of the European Union. Membership is associated with respective benefits or losses for each population type, with the aggregate benefit being positive.

This total effect of Membership is **assumed** to be positive (A1). This assumption is open to debate and it will be later examined in the context of the CEECs. Furthermore, prior benefits from Membership become attainable in the model in the short and long run. These could be the effects of increased trade or increased Foreign Direct Investment (FDI) and these effects are distributed unequally throughout the population. These prior benefits depend on the number of reforms implemented, which is modelled by using the dummy discount factors mentioned above.

The total combined effect of Reform 1 (TR1) on all types is **assumed** to be positive (A2), whereas the total combined effect of Reform 2 (TR2) on all types is **assumed** to be negative (A3). These two assumptions are designed to simplify the analysis. Any strategy, which postpones the second reform, can only work if the second set of reforms has a negative effect in aggregate, which is then discounted to the present. To postpone positive reforms only means fewer benefits are obtained presently, while incurring costs for the postponement. Thus, if there are only gains from reforms, implementing all reforms as early as possible is always optimal, while if there are only losses, implementing the reforms as late as possible is optimal. These scenarios appear to be extremely unrealistic and thus the model discusses separable reforms with distinctly different effects.

The initial analysis excludes the effect of any complementarity of reforms. The model is, however, extended in the next section to include the effect of complementary reforms. The extension of the analysis in the next section will relax the assumption of independent benefits and losses from different events. Complementarity of adjustments can also exist when the benefits or losses of each adjustment depend on the prior or simultaneous implementation of another measure. These cases certainly do exist in the case of transition and justify examination in greater detail (See for example Roland, 1994, and Friedman and Johnson, 1996). This model can be extended to take account of these cases and it therefore offers a basic framework in which these cases can be examined. This does not invalidate the conclusions reached in this section, but rather, it suggests that each adjustment has to be examined carefully to determine whether complementarities exist and there is a need to expand the present framework, to consider these cases.

When discussing the validity of the assumptions, it is important to note that this model does not actually assess the desirability of membership of the CEECs, but takes this desirability as an a priori assumption, as given by A1. The model does not examine a case for or against membership, but takes the decision to join the EU as given, and then tries to find an optimal process.

The assumption A1 reflects this consideration and, as such, is open to debate. In light of the strong commitments of most Eastern European countries to speedy accession to the EU, there seems to be a conviction within the CEECs that this holds true and it is taken as the basis of the model. Furthermore, there is a strong consensus among economists that EU membership would be beneficial economically and politically for the CEECs (See for example Gros & Steinherr, 1995, Part V, Chapter 16, 5.)

The EU's benefits are mainly presented in economic terms:

"On balance, enlargement should be economically beneficial for the Union because it is likely to lead to better performances ... " (Graham Avery and Fraser Cameron, p. 141, 1998).

In general, the desirability of Eastern enlargement, under the right conditions, is taken as a given. It can be argued that the EU would not enter into the accession process if no benefits were present on both sides.

Assumptions A2 and A3 can be treated together as their main emphasis is on a separability of reforms into two or more groups where at least one of these groups contains reforms or adaptations to EU practice, which convey a benefit to a majority of the population while another group conveys a loss to the majority of the population. There is a good case to be made for the existence of such groups of adjustments. The analysis could be extended to incorporate a variety of groups; some which might then be implemented together to avoid Political Feasibility constraints and thus finding a feasible and optimal path. It is not possible to create such complementarity of outcomes with only two groups of reforms and, as such, this remains a possible extension of the model.

The model also includes a negative effect on one group of society. While the exact size of this group is debatable, it is unlikely that no such group exists. Vaclav Prucha notes:



“The exaggerated restrictive policy of 1991-92 which has been conducive to a steep decline of production and labour productivity has reduced the resources available for investment and welfare purposes. This has slowed down the restructuring of the economy, constrained environmental policy and made it necessary to abolish some welfare measures from the past. At the same time, however, the sums of money expended as support to the unemployed show a continuous increase. Owing to the fact that the adverse effects of economic depression have had different intensities in different regions and in different professional groups, conditions have been created for national, social and regional conflicts” (in Teichova, 1997, p. 35).

The costs and benefits of reforms, as well as Membership, are summarised in Table 4.b.1:

Table 4.b.1: Cost/benefit Table of events

	Type A	Type B	Type C
Reform 1 (R <sub>1</sub> )	G <sub>1A</sub>	G <sub>1B</sub>	-L <sub>1C</sub>
Reform 2 (R <sub>2</sub> )	G <sub>2A</sub>	-L <sub>2B</sub>	-L <sub>2C</sub>
Membership (M)	m	M	-m

Both reforms are necessary conditions to realise the cost or benefit from membership. Thus, an option value of reversal does not exist, as the aggregate effect of membership outweighs the aggregate effect of both reforms.

The government can use three strategies to implement reforms - "Big Bang Now" (BBN), "Big Bang Later" (BBL) or "Gradualism" (GRAD). These strategies reflect a different sequence of reforms over time and are summarised in tables 4.b.2 to 4.b.4. The Big Bang Now strategy consists of an introduction of all reforms in the Short Run as seen in Table 4.b.2:

**Table 4.b.2: Time Table for "Big Bang Now" (BBN)**

	Discount factor:	Event:
Short Run (SR)	1	$R_1, R_2$
Long Run (LR)	$D_{LR}$	None
Membership (M)	$D_M$	M

where  $1 > D_{LR} > D_M > 0$ .

The Big Bang Later strategy introduces all reforms in the long run, which is seen in Table 4.b.3:

**Table 4.b.3: Time Table for "Big Bang Later" (BBL)**

	Discount factor:	Event:
Short Run (SR)	1	None
Long Run (LR)	$D_{LR}$	$R_1, R_2$
Membership (M)	$D_M$	M

The final strategy, Gradualism, distributes the reforms over time. Reform 1 is introduced in the Short Run, while Reform 2 is introduced in the Long Run for the reasons mentioned above. This is shown in Table 4.b.4:

**Table 4.b.4: Time Table for "Gradualism" (GRAD)**

	Discount factor:	Event:
Short Run (SR)	1	$R_1$
Long Run (LR)	$D_{LR}$	$R_2$
Membership (M)	$D_M$	M

In the Short Run and the Long Run, some prior benefits or losses from approaching membership become available. These are calculated by using the following formula:

$$P = \alpha d_1 d_2 (\text{loss/benefit from membership for each type}),$$

where  $\alpha$  is a proportion of loss or benefit from membership ( $1 > \alpha > 0$ ) and  $d_1$  and  $d_2$  are dummy discount variables taking values according to  $1 > d_1, d_2 > 0$

if  $R_1$  or  $R_2$  are not implemented and taking the values of  $d_1, d_2 = 1$  in the period after the reform is implemented. These prior benefits, applied to each strategy, are summarised in table 4.b.5:

**Table 4.b.5: Prior benefits of approaching membership applied to strategies**

	SR	LR
BBN	$\alpha d_1 d_2 (\text{loss/benefit from membership})$	$\alpha (\text{loss/benefit from membership})$
BBL	$\alpha d_1 d_2 (\text{loss/benefit from membership})$	$\alpha d_1 d_2 (\text{loss/benefit from membership})$
GRAD	$\alpha d_1 d_2 (\text{loss/benefit from membership})$	$\alpha d_2 (\text{loss/benefit from membership})$

To calculate Political Feasibility for myopic voters, the sign of the sum of all benefits and losses for each type in each period is taken. To examine Political Feasibility with fully rational voters, the sum of all present and all discounted future losses and benefits for each type in the long and short run is taken. Thus, the Total Present Value is calculated by discounting future events and adding them to the short run benefits and losses for each type, whereas the Total Future Values treats the long run as if the economy is at that stage already. Thus past losses and benefits are ignored as they can be considered as sunk costs, i.e.  $D_{LR}=D_{SR}=1$ . Using this information we can calculate all costs and benefits for each type in all periods, as well as Present and Future Values, under each strategy.

It is important to note that these costs and benefits can contain intangible costs and benefits as well as direct economic gains or losses. These could include political benefits from increased security as well as some kind of "feel good" factor. Furthermore, to determine Political Feasibility these values can be expected losses and benefits when taking account of future outcomes, as voting decisions will be taken on expectations of future outcomes. These expectations can, to some degree, be seen as self-fulfilling and they will thus play a crucial role in the accession process.

**Chapter 4: The Model**

**c) Political Feasibility**

To analyse the political constraints and optimality of each strategy we can now construct tables showing the costs and benefits, or expected costs and benefits, of each type. These tables are constructed by firstly entering all direct gains and losses associated with each event for each type. These will occur in different time periods under different strategies. These can thus be ordered by using the timetables shown in the tables 4.b.2 to 4.b.4. We then add the prior benefits or losses, according to Table 4.b.5. To calculate the Total Present Value, we add the discounted future outcomes to the Short Run gains and losses. These are discounted depending on the period in which they occur. The Total Future Value is calculated by adding the discounted benefits or losses from Membership to the Long Run gains and losses. The right hand side provides a check on whether the sum in the appropriate row is positive, negative or indeterminate. This is done for all types under each strategy as seen in tables 4.c.1 to 4.c.3. The maximum benefit from membership, prior and discounted values, is summarised as Km to show the loss which occurs when a strategy defers implementation of adjustments until the future. Thus we can construct the following tables for each type under each strategy.

The benefits and losses of all types under Big Bang Now are shown in tables 4.c.1 to 4.c.3:

**Table 4.c.1: Benefits/Losses under BBN for Type A**

	Benefits/losses	Positive?
SR	$G_{1A}+G_{2A}+\alpha d_1 d_2 m$	✓
LR	$\alpha m$	✓
M	$m$	✓
Total Present Value:	$G_{1A}+G_{2A}+\alpha d_1 d_2 m+d_{LR}\alpha m+d_M m=$ $G_{1A}+G_{2A}+(\alpha d_1 d_2+d_{LR}\alpha+d_M)m=$ $G_{1A}+G_{2A}+Km$	✓
Total Future Value:	$\alpha m+(d_M/d_{LR}) m$	✓

Where  $K=\alpha d_1 d_2+d_{LR}\alpha+d_M$  represents the total possible gain from membership.

**Table 4.c.2: Benefits/Losses under BBN for Type B**

	Benefits/losses	Positive?
SR	$G_{1B}-L_{2B}+\alpha d_1 d_2 m$	?
LR	$\alpha m$	✓
M	$m$	✓
Total Present Value:	$G_{1B}-L_{2B}+\alpha d_1 d_2 m+d_{LR}\alpha m+d_M m=$ $G_{1B}-L_{2B}+(\alpha d_1 d_2+d_{LR}\alpha+d_M)m=$ $G_{1B}-L_{2B}+Km$	?
Total Future Value:	$\alpha m+(d_M/d_{LR})m$	✓

**Table 4.c.3: Benefits/Losses under BBN for Type C**

	Benefits/losses	Positive?
SR	$-L_{1C}-L_{2C}-\alpha d_1 d_2 m$	✗
LR	$-\alpha m$	✗
M	$-m$	✗
Total Present Value:	$-L_{1C}-L_{2C}-\alpha d_1 d_2 m-d_{LR}\alpha m-d_M m=$ $-L_{1C}-L_{2C}-(\alpha d_1 d_2+d_{LR}\alpha+d_M)m=$ $-L_{1C}-L_{2C}-Km$	✗
Total Future Value:	$-\alpha m-(d_M/d_{LR})m$	✗

Similarly, the benefits and losses of all types under Big Bang Later are shown in the tables 4.c.4, 4.c.5 and 4.c.6:

**Table 4.c.4: Benefits/Losses under BBL for Type A**

	Benefits/losses	Positive?
SR	$\alpha d_1 d_2 m$	✓
LR	$G_{1A}+G_{2A}+d_1 d_2 \alpha m$	✓
M	M	✓
Total Present Value:	$D_{LR}G_{1A}+d_{LR}G_{2A}+\alpha d_1 d_2 m+d_{LR}\alpha d_1 d_2 m+d_M m=$ $d_{LR}(G_{1A}+G_{2A})+Km+d_{LR}\alpha d_1 d_2 m-d_{LR}\alpha m=$ $d_{LR}(G_{1A}+G_{2A})+Km-(1-d_1 d_2)d_{LR}\alpha m$	✓
Total Future Value:	$G_{1A}+G_{2A}+d_1 d_2 \alpha m+(d_M/d_{LR})m$	✓

**Table 4.c.5: Benefits/Losses under BBL for Type B**

	Benefits/losses	Positive?
SR	$\alpha d_1 d_2 m$	✓
LR	$G_{1B}-L_{2B}+d_1 d_2 \alpha m$	?
M	m	✓
Total Present Value:	$D_{LR}G_{1B}-d_{LR}L_{2B}+\alpha d_1 d_2 m+d_{LR}\alpha d_1 d_2 m+d_M m=$ $d_{LR}(G_{1B}-L_{2B})+Km+d_{LR}\alpha d_1 d_2 m-d_{LR}\alpha m=$ $D_{LR}(G_{1B}-L_{2B})+Km-(1-d_1 d_2)d_{LR}\alpha m$	?
Total Future Value:	$G_{1B}-L_{2B}+d_1 d_2 \alpha m+(d_M/d_{LR})m$	?



**Table 4.c.6: Benefits/Losses under BBL for Type C**

	Benefits/losses	Positive?
SR	$-\alpha d_1 d_2 m$	✗
LR	$-L_1 C - L_2 C - d_1 d_2 \alpha m$	✗
M	$-m$	✗
Total Present Value:	$-d_{LR} L_1 C - d_{LR} L_2 C - \alpha d_1 d_2 m - d_{LR} \alpha d_1 d_2 m - d_M m =$ $-d_{LR} (L_1 C + L_2 C) - K m - d_{LR} \alpha d_1 d_2 m + d_{LR} \alpha m =$ $-d_{LR} (L_1 C + L_2 C) - K m + (1 - d_1 d_2) d_{LR} \alpha m$	✗
Total Future Value:	$-L_1 C - L_2 C - d_1 d_2 \alpha m - (d_M / d_{LR}) m$	✗

And finally, the benefits and losses of all types under Gradualism are shown in tables 4.c.7 to 4.c.9:

**Table 4.c.7: Benefits/Losses under GRAD for Type A**

	Benefits/losses	Positive?
SR	$G_{1A} + \alpha d_1 d_2 m$	✓
LR	$G_{2A} + d_2 \alpha m$	✓
M	$M$	✓
Total Present Value:	$G_{1A} + d_{LR} G_{2A} + \alpha d_1 d_2 m + d_{LR} \alpha d_2 m + d_M m =$ $G_{1A} + d_{LR} G_{2A} + K m + d_{LR} \alpha d_2 m - d_{LR} \alpha m =$ $G_{1A} + d_{LR} G_{2A} + K m - (1 - d_2) d_{LR} \alpha m$	✓
Total Future Value:	$G_{2A} + d_2 \alpha m + (d_M / d_{LR}) m$	✓

Table 4.c.8: Benefits/Losses under GRAD for Type B

	Benefits/losses	Positive?
SR	$G_{1B} + \alpha d_1 d_2 m$	✓
LR	$-L_{2B} + d_2 \alpha m$	?
M	M	✓
Total Present Value:	$G_{1B} - d_{LR} L_{2B} + \alpha d_1 d_2 m + d_{LR} \alpha d_2 m + d_M m =$ $G_{1B} - d_{LR} L_{2B} + K m + d_{LR} \alpha d_2 m - d_{LR} \alpha m =$ $G_{1B} - d_{LR} L_{2B} + K m - (1 - d_2) d_{LR} \alpha m$	?
Total Future Value:	$-L_{2B} + d_2 \alpha m + (d_M / d_{LR}) m$	?

Table 4.c.9: Benefits/Losses under GRAD for Type C

	Benefits/losses	Positive?
SR	$-L_{1C} - \alpha d_1 d_2 m$	✗
LR	$-L_{2C} - d_2 \alpha m$	✗
M	-m	✗
Total Present Value:	$-L_{1C} - d_{LR} L_{2C} - \alpha d_1 d_2 m - d_{LR} \alpha d_2 m - d_M m =$ $-L_{1C} - d_{LR} L_{2C} - K m - d_{LR} \alpha d_2 m + d_{LR} \alpha m =$ $-L_{1C} - d_{LR} L_{2C} - K m + (1 - d_2) d_{LR} \alpha m$	✗
Total Future Value:	$-L_{2C} - d_2 \alpha m - (d_M / d_{LR}) m$	✗

We can now establish conditions to determine whether a strategy is Politically Feasible. Assuming that voters are fully rational, a strategy is only Politically Feasible if the majority of voters will experience a positive outcome in each period when all future outcomes are taken into account. Thus, we can establish the first Political Feasibility condition:

Political Feasibility condition (I) (assuming fully rational voters):

Assuming fully rational voters, a strategy is **Politically Feasible** if, and only if, at least two out of three types will experience a total positive present value of all present and future outcomes in any given period.

When assuming that voters are myopic no future values are taken into account. A strategy is thus only Politically Feasible if the majority of voters have a positive outcome in each period. Thus we can establish the following condition:

Political Feasibility condition (II) (assuming myopic voters):

*Assuming myopic voters, a strategy is **Politically Feasible** if, and only if, at least two out of three types will have a positive outcome of events in any given period.*

Given these two constraints we can determine which strategy is optimal by calculating the total present value of each strategy across voters. By comparing these values between strategies, we can determine under what circumstances each strategy yields the maximum amount of economic benefits. Thus, we can establish the following condition to determine optimality:

Optimality condition:

*A strategy is **optimal** if, and only if, the sum of all present values across all types is greater than the sum of present values of all types of any other given strategy.*

The Political Feasibility conditions both depend crucially on the outcomes of each strategy for Type B, as the outcomes of any given strategy are always positive for Type A and always negative for Type C, as one can see when examining the tables 4.c.1 to 4.c.9. Type B thus represents the median voter or swing voter.

By taking the relevant values from the tables, we can thus construct a table of rational (I) Political Feasibility conditions. Type B is the important group to examine, but we also need to look at different periods for each strategy. For the Big Bang Now strategy, it is clear that we have to examine the Total Present Value of Type B, as the Total Future Value is always positive. For the Big Bang Later strategy we have to examine the Total Future

Value. If the Total Future Value is positive, then the Total Present Value will be positive, as this means adding a discounted positive value to a positive value in the Short Run. For Gradualism, we need to examine the Long Run as the Short Run is always positive. Again we will use the Total Future Value to determine whether this strategy is Politically Feasible (I). Thus, we can construct the following table of Political Feasibility (I) conditions:

**Table 4.c.10: Rational (I) Political Feasibility Conditions**

	Feasible (I) if, and only if,:
BBN	$G_{1B}-L_{2B}+K_m>0$
BBL	$G_{1B}-L_{2B}+d_1d_2\alpha_m+(d_M/L_{LR})_m>0$
GRAD	$-L_{2B}+d_2\alpha_m+(d_M/L_{LR})_m>0$

This table demonstrates that as long as membership is attained, and there is a positive effect of membership, all strategies are probably Politically Feasible, when assuming rational voters. This is because a small loss from the second reform is outweighed by gains to be made in the future and realised gains before that. One should note that Big Bang Now is the strategy, which fulfils the condition most easily, while the comparison between Big Bang Later and Gradualism depends upon the size of gains from the first reform and the dummy discount factor associated with the first reform.

Similarly we can establish the following table of conditions of myopic (II) Political Feasibility. These come from those periods, which might be negative, i.e. the short run for Big Bang Now and the Long Run for Big Bang Later and for Gradualism.

**Table 4.c.11: Myopic (II) Feasibility Conditions**

	Feasible (II) if, and only if,:
BBN	$G_{1B}-L_{2B}+\alpha d_1 d_2 m > 0$
BBL	$G_{1B}-L_{2B}+\alpha d_1 d_2 m > 0$
GRAD	$-L_{2B}+d_2 \alpha m > 0$

Assuming myopic voters, we can see that the feasibility conditions of Big Bang Now and Big Bang Later are identical as they represent the same process, only delayed into the future. This is irrelevant for the myopic voter as, here, future outcomes are ignored in each period and thus the voting condition is identical. These conditions are fulfilled easily, as long as the loss of the second reform of Type B is not excessive. Gradualism is more constrained in its feasibility (II). Here, a small loss of the second reform to Type B, a high benefit from membership, a low importance of the second reform and a high proportion of benefits from membership occurring prior to membership, all contribute to Political Feasibility (II). This shows that the Political Feasibility (II), assuming myopic voters, is more difficult to achieve than the Political Feasibility (I), assuming rational voters, as the myopic voter reacts inherently irrationally by ignoring future benefits. This means that if voters are strongly myopic Big Bang Now might be the only strategy which is feasible. Comparing the two conditions directly we can construct the following table:

**Table 4.c.12: Comparing Rational (I) and Myopic (II) Feasibility**

	Feasible (I) if, and only if,:	Feasible (II) if, and only if,:
BBN	$G_{1B}-L_{2B}+K m > 0$	$G_{1B}-L_{2B}+\alpha d_1 d_2 m > 0$
BBL	$G_{1B}-L_{2B}+d_1 d_2 \alpha m+(d_M/L_{LR})m > 0$	$G_{1B}-L_{2B}+\alpha d_1 d_2 m > 0$
GRAD	$-L_{2B}+d_2 \alpha m+(d_M/L_{LR})m > 0$	$-L_{2B}+d_2 \alpha m > 0$

This table shows clearly that it is easier to fulfil the Political Feasibility condition (I) than to achieve Political Feasibility (II). In fact, any strategy, which is feasible assuming myopic voters, will also be feasible for rational

voters. Thus, finding a strategy which is optimal and Politically Feasible with myopic voters, will be necessarily feasible with rational voters.

We can now determine how the strategies compare to each other. To construct the optimality condition we will firstly sum the present value of all types for each strategy, as demonstrated in table 4.c.13 to 4.c.15:

**Table 4.c.13: Summation of Benefits/Losses of "Big Bang Now"**

	Present Value:
Type A	$G_{1A}+G_{2A}+Km$
Type B	$G_{1B}-L_{2B}+Km$
Type C	$-L_{1C}-L_{2C}-Km$
Total	$G_{1A}+G_{2A}+G_{1B}-L_{2B}-L_{1C}-L_{2C}+Km$

**Table 4.c.14: Summation of Benefits/Losses of "Big Bang Later"**

	Present Value:
Type A	$D_{LR}(G_{1A}+G_{2A})+Km-(1-d_1d_2)\alpha d_{LRm}$
Type B	$D_{LR}(G_{1B}-L_{2B})+Km-(1-d_1d_2)\alpha d_{LRm}$
Type C	$D_{LR}(-L_{1C}-L_{2C})-Km+(1-d_1d_2)\alpha d_{LRm}$
Total	$D_{LR}(G_{1A}+G_{2A}+G_{1B}-L_{2B}-L_{1C}-L_{2C})+Km-(1-d_1d_2)\alpha d_{LRm}$

**Table 4.c.15: Summation of Benefits/Losses of "Gradualism"**

	Present Value:
Type A	$D_{LR}(G_{1A}+G_{2A})+Km-(1-d_2)\alpha d_{LRm}$
Type B	$D_{LR}(G_{1B}-L_{2B})+Km-(1-d_2)\alpha d_{LRm}$
Type C	$D_{LR}(-L_{1C}-L_{2C})-Km+(1-d_2)\alpha d_{LRm}$
Total	$D_{LR}(G_{1A}+G_{2A}+G_{1B}-L_{2B}-L_{1C}-L_{2C})+Km-(1-d_2)\alpha d_{LRm}$

By using these present values of outcomes from all types, we can create the following pay-off table for all strategies which allows a direct comparison:

**Table 4.c.16: Pay-off table for all strategies**

	Reform 1	Reform 2	membership	loss of waiting
BBN	$TR_1$	$TR_2$	$Km$	0
BBL	$D_{LR}TR_1$	$d_{LR}TR_2$	$Km$	$-(1-d_1d_2)\alpha d_{LRm}$



GRAD	TR <sub>1</sub>	d <sub>LR</sub> TR <sub>2</sub>	K <sub>m</sub>	-(1-d <sub>2</sub> )αd <sub>LRm</sub>
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Where TR<sub>1</sub>=G<sub>1</sub>A+G<sub>1</sub>B-L<sub>1</sub>C and TR<sub>2</sub>=G<sub>2</sub>A-L<sub>2</sub>B-L<sub>2</sub>C.

We can now compare the different outcomes from each strategy with each other. Firstly, we will compare Big Bang Now to Big Bang Later. For any strategy to be optimal in comparison to another, the sum of all present values of all types of that strategy must be strictly greater than the sum of all present values of the other strategy. Thus:

BBN will be optimal in comparison to BBL if, and only if,

$$TR_1+TR_2+K_m > d_{LR}TR_1+d_{LR}TR_2+K_m-(1-d_1d_2)\alpha d_{LRm}$$

Cancelling the identical terms:

$$TR_1+TR_2 > d_{LR}TR_1+d_{LR}TR_2-(1-d_1d_2)\alpha d_{LRm}$$

This illustrates that the only way this condition will not hold is if either the total effect of one reform is strongly negative or if the combined effect of two negative reforms is relatively large in comparison to the loss from waiting. Because of A2 and A3, this must mean that BBN is only not optimal in comparison to BBL if the second reform is strongly negative.

Similarly we can compare Gradualism to Big Bang Later:

GRAD will be optimal in comparison to BBL if, and only if,

$$TR_1+d_{LR}TR_2+K_m-(1-d_2)\alpha d_{LRm} > d_{LR}TR_1+d_{LR}TR_2+K_m-(1-d_1d_2)\alpha d_{LRm}$$

Cancelling the identical terms:

$$TR_1-(1-d_2)\alpha d_{LRm} > d_{LR}TR_1-(1-d_1d_2)\alpha d_{LRm}$$

Rearranging:

$$TR_1 > [(1-d_2)-(1-d_1d_2)]\alpha d_{LRm}+d_{LR}TR_1$$

$$TR_1 > [-d_2+d_1d_2]\alpha d_{LRm}+d_{LR}TR_1$$

$$TR_1 > -[1-d_1]d_2\alpha d_{LRm}+d_{LR}TR_1$$

We now have a negative term on the RHS and the discounted value of the first reform, compared to the full value of the first reform on the LHS. The only way this equation does not hold is if the first reform has a negative effect. This means that given A2, Big Bang Later is never optimal in comparison to Gradualism.

Finally we can compare Gradualism to Big Bang Now:

GRAD is optimal in comparison to BBN if, and only if,

$$TR_1 + d_{LR}TR_2 + Km - (1 - d_2)\alpha d_{LR}m > TR_1 + TR_2 + Km$$

Cancelling the identical terms:

$$d_{LR}TR_2 - (1 - d_2)\alpha d_{LR}m > TR_2$$

This is more difficult to interpret. As the second reform is negative (A3), this condition holds only with certain parameter values. In particular, the condition holds if there is a strong LR discount, i.e. if it has a small value, if the effect of the second reform is relatively large in comparison to the benefit from membership, if a relatively small proportion of gains or losses from membership are realised a priori and if the second reforms are relatively important in comparison to other reforms, i.e. the dummy discount factor is low.

As Gradualism is always preferable to Big Bang Later in this model, these are the conditions which will be the deciding factor in choosing between Gradualism and Big Bang Now. Big Bang Later will always be disregarded, because if Big Bang Later is preferred to Big Bang Now, Gradualism will always be chosen. If Big Bang Now is preferable to Big Bang Later, the above conditions apply, as they will determine whether Gradualism is optimal in comparison to Big Bang Now.

Thus, we can conclude that in the given model, Big Bang Later will never be chosen. In addition, there are conditions under which Gradualism is

preferable to Big Bang Now and there are conditions under which the opposite applies.

Given that the feasibility condition is harder to fulfil for Gradualism than for Big Bang Now, are there circumstances under which Gradualism is optimal and Politically Feasible? We can check this by using the feasibility condition (II) as an identity and introducing it into the optimality condition.

Feasibility condition (for GRAD):

$$-L_{2B} + d_2 \alpha m = 0$$

$$-L_{2B} = -d_2 \alpha m$$

Optimality condition:

$$dLR TR_2 - (1 - d_2) \alpha dLRm > TR_2$$

Replacing  $TR_2$  with the identity  $TR_2 = (G_2A - L_{2B} - L_{2C})$  defined before:

$$dLR(G_2A - L_{2B} - L_{2C}) - (1 - d_2) \alpha dLRm > (G_2A - L_{2B} - L_{2C})$$

Substituting the feasibility condition into the equation:

$$dLR(G_2A - d_2 \alpha m - L_{2C}) - (1 - d_2) \alpha dLRm > (G_2A - d_2 \alpha m - L_{2C})$$

This can be rearranged to:

$$-(1 - dLR)G_2A - (1 - dLR)(-L_{2C}) - (1 - dLR)(-\alpha dLRm) - (1 - d_2) \alpha dLRm > 0$$

Multiplying by (-1) and rearranging yields:

$$(1 - dLR)L_{2C} > (1 - dLR)G_2A + (dLR + d_2) \alpha dLRm$$

It is clear that, given certain parameter values, Gradualism will fulfil both conditions simultaneously. Thus, **"Gradualism" can be Politically Feasible and optimal**, notably depending on low discount factors and an unequal negative distribution of the second reform. This does not mean that Gradualism will always be favourable. Notably, if one looks at the three assumptions, they will be crucial in determining whether Gradualism is optimal. In particular, there must be a distinctive set of reforms which is separable from the other reforms and which, in aggregate, has an unequal negative effect on substantial parts of the population. The adjustment with a

negative effect can be postponed into the future and will thus be discounted at the present time. Furthermore, there must be a "price" which can be gained (in this case benefits from membership), which is desirable for a majority of the population. Examining the Political Feasibility Condition for "Gradualism" highlights the conditions under which Gradualism will have a political constituency. The Political Feasibility condition of Gradualism is given by the following condition:

$$-L_2B+d_2\alpha m>0$$

This condition is likely to hold in the CEECs, as there are some reforms, which will have a negative effect on most parts of the population without being excessively negative for the swing voter. These could, for example, include adapting the legal system to EU standards, which would only carry a limited administrative fee. This would then have to be paid for by taxes or fees. The negative effects from certain reforms would, however, be outweighed by the gain from membership, which is realised partially before accession ( $\alpha m$ ), even if it is discounted for the importance of these negative reforms ( $d_2$ ). Thus, it seems that there are a number of reforms where the feasibility condition for Gradualism might hold. This is even more likely if one considers the strength of this condition. It does only refer to voters with limited rationality. If people do take into account future outcomes, then it is much easier to implement these reforms as one approaches membership, as the benefits from membership are taken into account to a stronger degree. Thus Political Feasibility will be easier to fulfil if people are rational - making the case for Gradualism stronger.

Examining the conditions for optimality of Gradualism gives an indication for the circumstances under which the CEECs should pursue a gradual accession path. The optimality condition for Gradualism has been derived as:

$$d_L R T R_2 - (1 - d_2) \alpha d_L R m > T R_2$$

This condition holds if the second reform is substantially negative for the population as a whole, while a strong future discount ( $d_{LR}$ ) and a low importance of these reforms ( $d_2$ ) could serve to reduce the size of benefits from membership, making Gradualism feasible. As there are substantial negative adjustments, like the Common Agricultural Policy (CAP), and a strong future discount, due to a substantial time period until accession, there are good arguments for at least a limited form of Gradualism for these countries.

In this context, an important extension of the framework will have to be an assessment of uncertainties on this process. Uncertainty will be crucially important in determining whether a strategy is time consistent, as well as having an important impact on the realisation of prior gains and on the various discount rates. The framework can be extended to include uncertainties and the effect of uncertainty will be an important constraint on policy-making. The possibility of CEE governments reneging on previous announcements will also have to be considered. This commitment problem, termed Time Inconsistency, can also be accommodated by the model and will be examined later. The analysis of Time Inconsistency will be conducted in section e) of this chapter, while Uncertainty will be examined in section f).

It is important to stress that in all the CEECs, there is evidence of constraints, albeit being dissimilar in a variety of other characteristics. The evidence for constraints will be examined in greater detail in Chapter 5. Strong constraints could make gradual adjustment optimal and Politically Feasible for all CEECs. The speed of these adjustments does, however, depend upon the stage of the country at present, as this will crucially determine Political Feasibility. The different time periods until these countries are permitted to join and their prospective benefits from membership will crucially influence Political Feasibility. For a more specific analysis of countries for which gradual adjustments are optimal, the constraints in the applicant countries have to be examined in more detail in Chapter 5.

**Chapter 4: The Model**  
**d) Complementarities**

Within the context of economic reforms in Central and Eastern Europe, it is essential to consider the interaction of adjustments. These cases certainly do exist in the case of transition and merit further investigation (See for example Roland, 1994, and Friedman and Johnson, 1996).

In particular one has to consider that adjustments introduced simultaneously can have complementary effects. This would mean that a reform could be more effective in conjunction with a second reform, as is possibly the case when introducing price reforms and privatisation. There is, however, the possibility that reforms will have a negative effect when introduced simultaneously (for example by increasing uncertainty and reducing distributive welfare). To model these interactions, the model introduced in the previous section of this thesis will be used, with the addition of a switching variable modelling complementarity. This variable will be a factor,  $C_{nm}$ , which is multiplied with the total effect of a particular reform,  $(TR_n)$ , as soon as the complementary reform ( $R_m$ ) is introduced. These factors can be positive or negative, reflecting the direction of the interaction between the adjustments. Thus in the case of two reforms,  $R_1$  and  $R_2$ , the effect of  $R_1$  being introduced by itself is given by  $TR_1$ , whereas the simultaneous introduction of Reform 2 will add or subtract a term  $C_{12}TR_1$  to this effect. Thus, the total effect will be  $(1 + C_{12})TR_1$ . As the second reform is similarly affected, the total effect of Reform 2 is  $(1 + C_{21})TR_2$ , where  $C_{12}$  and  $C_{21}$  are not necessarily equal or might even have different signs. Thus, we can show the effect of complementarities in the following table:

**Table 4.d.1: Complementarities of 2 Reforms**

Already in place or introduced simultaneously:	If R <sub>1</sub> is introduced	If R <sub>2</sub> is introduced
R <sub>1</sub>	TR <sub>1</sub>	C <sub>21</sub> TR <sub>2</sub>
R <sub>2</sub>	C <sub>12</sub> TR <sub>1</sub>	TR <sub>2</sub>

This can easily be expanded to any number of reforms. Table 4.d.2 shows this for 3 reforms.

**Table 4.d.2: Complementarities of 3 Reforms**

Already in place or introduced simultaneously:	If R <sub>1</sub> is introduced	If R <sub>2</sub> is introduced	If R <sub>3</sub> is introduced
R <sub>1</sub>	TR <sub>1</sub>	C <sub>21</sub> TR <sub>2</sub>	C <sub>31</sub> TR <sub>3</sub>
R <sub>2</sub>	C <sub>12</sub> TR <sub>1</sub>	TR <sub>2</sub>	C <sub>32</sub> TR <sub>3</sub>
R <sub>3</sub>	C <sub>13</sub> TR <sub>1</sub>	C <sub>23</sub> TR <sub>2</sub>	TR <sub>3</sub>

If any of these are not introduced simultaneously, then the effect can easily be seen by deleting the relevant row and column. The focus will be on the interaction of 2 reforms as this means fewer permutations, without losing the analysis of the essence of complementarity in reform strategies.

Inevitably, these complementarities are difficult to measure. By their nature, the effect of complementarities can only be determined *ex post* and in comparison to a modelled counterfactual. However, for public policy decisions, judgements have to be made *ex ante*. These will have to be based on estimates, which are difficult to construct. However, modelling possible complementarities can help to construct estimates. Furthermore, these estimates can be used to give an indication of the sign of complementarities, which will be crucial in determining the success of different accession strategies.

Thus, when considering the different strategies we can summarise the effects of each of the complementarities in the following table:



**Table 4.d.3: Total effects of both reforms under each strategy including complementarities.**

	BBN	BBL	GRAD
SR	$TR_1+C_{12}TR_1+TR_2+C_{21}TR_2 = (1+C_{12})TR_1+(1+C_{21})TR_2$	0	$TR_1$
LR	0	$TR_1+C_{12}TR_1+TR_2+C_{21}TR_2 = (1+C_{12})TR_1+(1+C_{21})TR_2$	$TR_2+C_{21}TR_2 = (1+C_{21})TR_2$

We can use this information to analyse the effect of complementarities on Political Feasibility. Here we assume that the effect of the complementarity on each population group will be determined by the same factor affecting the outcome of the reform as a whole. This means that additional to the gain or loss of each population group, the switching factor, when appropriate, multiplied by the individual gain or loss will be added. We can thus construct the table with the Rational Feasibility Conditions for each strategy<sup>78</sup>.

**Table 4.d.4: Rational (I) Political Feasibility Conditions**

	Feasible (I) if and only if:
BBN	$(1+C_{12})G_{1B}-(1+C_{21})L_{2B}+K_m>0$
BBL	$(1+C_{12})G_{1B}-(1+C_{21})L_{2B}+d_1d_2\alpha_m+d_Mm>0$
GRAD	$-(1+C_{21})L_{2B}+d_2\alpha_m+d_Mm>0$

Similarly we can establish the following table of conditions of myopic (II) Political Feasibility.

<sup>78</sup> The gains and losses for each type are taken directly from the previous section, as well as the basic form of the political feasibility conditions.

**Table 4.d.5: Myopic (II) Political Feasibility Conditions**

	Feasible (II) if and only if:
BBN	$(1+C_{12})G_{1B}-(1+C_{21})L_{2B}+\alpha d_1 d_2 m > 0$
BBL	$(1+C_{12})G_{1B}-(1+C_{21})L_{2B}+\alpha d_1 d_2 m > 0$
GRAD	$-(1+C_{21})L_{2B}+d_2 \alpha m > 0$

Again the myopic feasibility condition is just a more stringent case of the rational feasibility condition and will thus be analysed to determine the effect of complementarity. As these switching factors can have different signs, it is most appropriate to show their effect by using the following tables. In the first table, the effect of complementarities on both BBN and BBL are analysed as the effect on myopic feasibility is identical:

**Table 4.d.6: Effect of Complementarity on Political Feasibility of BBN and BBL, depending on the sign of the switching variable**

	Signed additional term	Effect on Political Feasibility
$C_{12}^+; C_{21}^+$	$C_{12}^+G_{1B}^+-C_{21}^+L_{2B}^+$	indeterminate
$C_{12}^+; C_{21}^-$	$C_{12}^+G_{1B}^+-C_{21}^-L_{2B}^+$	reinforced
$C_{12}^-; C_{21}^+$	$C_{12}^-G_{1B}^+-C_{21}^+L_{2B}^+$	reduced
$C_{12}^-; C_{21}^-$	$C_{12}^-G_{1B}^+-C_{21}^-L_{2B}^+$	indeterminate

A similar table can be constructed for Gradualism:

**Table 4.d.7: Effect of Complementarity on Political Feasibility of GRAD, depending on the sign of the switching variable**

	Signed additional term	Effect on Political Feasibility
$C_{12}^{+}; C_{21}^{+}$	$-C_{21}^{+}L_{2B}^{+}$	reduced
$C_{12}^{+}; C_{21}^{-}$	$-C_{21}^{-}L_{2B}^{+}$	reinforced
$C_{12}^{-}; C_{21}^{+}$	$-C_{21}^{+}L_{2B}^{+}$	reduced
$C_{12}^{-}; C_{21}^{-}$	$-C_{21}^{-}L_{2B}^{+}$	reinforced

We can thus directly compare the effect of complementarities on Political Feasibility in the following table:

**Table 4.d.8: Effect of complementarities on Political Feasibility**

	Effect on Political Feasibility of BBN/BBL	Effect on Political Feasibility of GRAD
$C_{12}^{+}; C_{21}^{+}$	indeterminate	reduced
$C_{12}^{+}; C_{21}^{-}$	reinforced	reinforced
$C_{12}^{-}; C_{21}^{+}$	reduced	reduced
$C_{12}^{-}; C_{21}^{-}$	indeterminate	reinforced

It is thus clear that the existence of positive complementarities will reduce the Political Feasibility of Gradualism, while having an indeterminate effect on Big Bang Now and Big Bang Later. Similarly, the existence of negative complementarities reinforces the Political Feasibility of Gradualism, while having an indeterminate effect on Big Bang Now and Big Bang Later. The effect of a positive complementarity on the first reform combined with the effect of a negative complementarity on the second will reinforce Political Feasibility of both Big Bang and Gradual strategies, while the opposite combination reduces Political Feasibility for both types of strategy.

We can now compare the different strategies by using the previously stated Current Optimality condition.

Current Optimality condition:

A strategy is **currently optimal** if, and only if, the sum of all present values across all types is greater than the sum of present values of all types of any other given strategy.

By using these present values of outcomes from all types we can create the following pay-off table for all strategies, which allows a direct comparison<sup>79</sup>:

**Table 4.d.9: Pay-off table for all strategies**

	BBN	BBL	GRAD
Reform 1	TR <sub>1</sub>	d <sub>LR</sub> TR <sub>1</sub>	TR <sub>1</sub>
Reform 2	TR <sub>2</sub>	d <sub>LR</sub> TR <sub>2</sub>	d <sub>LR</sub> TR <sub>2</sub>
complementarity	C <sub>12</sub> TR <sub>1</sub> + C <sub>21</sub> TR <sub>2</sub>	d <sub>LR</sub> (C <sub>12</sub> TR <sub>1</sub> + C <sub>21</sub> TR <sub>2</sub> )	d <sub>LR</sub> (C <sub>21</sub> TR <sub>2</sub> )
membership	Km	Km	Km
loss of waiting	0	-(1-d <sub>1</sub> d <sub>2</sub> )αd <sub>LR</sub> m	-(1-d <sub>2</sub> )αd <sub>LR</sub> m

We can now compare the different outcomes from each strategy with each other. The same factors will apply as in the previous section with the addition of the variables expressing complementarity. As these can have different signs, each of the four permutations will be discussed in turn. Firstly, we will compare Big Bang Now to Big Bang Later. For any strategy to be optimal in comparison to another, the sum of all present values of all types of that strategy must be strictly greater than the sum of all present values of the other strategy. Thus:

<sup>79</sup> These terms, with the exception of the effect of complementarities, are taken directly from the previous section and will be later used to compare the optimality of the different strategies.

BBN will be optimal in comparison to BBL if, and only if:

$$TR_1 + TR_2 + Km + C_{12}TR_1 + C_{21}TR_2 >$$

$$d_{LR}TR_1 + d_{LR}TR_2 + Km + d_{LR}(C_{12}TR_1 + C_{21}TR_2) - (1 - d_1d_2)\alpha d_{LR}m$$

Cancelling the identical terms:

$$TR_1 + TR_2 + C_{12}TR_1 + C_{21}TR_2 >$$

$$d_{LR}TR_1 + d_{LR}TR_2 + d_{LR}(C_{12}TR_1 + C_{21}TR_2) - (1 - d_1d_2)\alpha d_{LR}m$$

$$TR_1 + TR_2 + (1 - d_{LR})(C_{12}TR_1 + C_{21}TR_2) >$$

$$d_{LR}TR_1 + d_{LR}TR_2 - (1 - d_1d_2)\alpha d_{LR}m$$

We can summarise the effect this variable will have in the following table<sup>80</sup>:

**Table 4.d.10: Effect of Complementarity on optimality depending on the sign of the switching variable; BBN over BBL**

	Signed additional term	Optimality of BBN over BBL
$C_{12}^+; C_{21}^+$	$(1 - d_{LR})^+(C_{12}^+TR_1^+ + C_{21}^+TR_2^-)$	small, indeterminate
$C_{12}^+; C_{21}^-$	$(1 - d_{LR})^+(C_{12}^+TR_1^+ + C_{21}^-TR_2^-)$	small, reinforced
$C_{12}^-; C_{21}^+$	$(1 - d_{LR})^+(C_{12}^-TR_1^+ + C_{21}^+TR_2^-)$	small, reduced
$C_{12}^-; C_{21}^-$	$(1 - d_{LR})^+(C_{12}^-TR_1^+ + C_{21}^-TR_2^-)$	small, indeterminate

Similarly we can compare Gradualism to Big Bang Later.

GRAD will be optimal in comparison to BBL if and only if:

$$TR_1 + d_{LR}TR_2 + Km + d_{LR}(C_{21}TR_2) - (1 - d_2)\alpha d_{LR}m >$$

$$d_{LR}TR_1 + d_{LR}TR_2 + Km + d_{LR}(C_{12}TR_1 + C_{21}TR_2) - (1 - d_1d_2)\alpha d_{LR}m$$

<sup>80</sup> This assumes (as in the previous section) that the first reform has a positive effect, while the second reform has a negative effect. This assumption will also be used when constructing tables 4.d.11 and 4.d.12.

Cancelling the identical terms:

$$TR_1 - (1-d_2)\alpha d_{LR}m > d_{LR}TR_1 - (1-d_1d_2)\alpha d_{LR}m + d_{LR}C_{12}TR_1$$

Rearranging:

$$TR_1 > [(1-d_2) - (1-d_1d_2)]\alpha d_{LR}m + d_{LR}TR_1 + d_{LR}C_{12}TR_1$$

$$TR_1 > [-d_2 + d_1d_2]\alpha d_{LR}m + d_{LR}TR_1 + d_{LR}C_{12}TR_1$$

$$TR_1 > -[1-d_1]d_2\alpha d_{LR}m + d_{LR}TR_1 + d_{LR}C_{12}TR_1$$

$$TR_1 - d_{LR}C_{12}TR_1 > d_{LR}TR_1 - [1-d_1]d_2\alpha d_{LR}m$$

We can thus construct the following table:

**Table 4.d.11: Effect of Complementarity on optimality depending on the sign of the switching variable; GRAD over BBL**

	Signed additional term	Optimality of GRAD over BBL
$C_{12}^+; C_{21}^+$	$-d_{LR}^+C_{12}^+TR_1^+$	reduced
$C_{12}^+; C_{21}^-$	$-d_{LR}^+C_{12}^+TR_1^+$	reduced
$C_{12}^-; C_{21}^+$	$-d_{LR}^+C_{12}^-TR_1^+$	reinforced
$C_{12}^-; C_{21}^-$	$-d_{LR}^+C_{12}^-TR_1^+$	reinforced

Finally we can compare Gradualism to Big Bang Now:

GRAD is optimal in comparison to BBN if and only if:

$$TR_1 + d_{LR}TR_2 + Km + d_{LR}(C_{21}TR_2) - (1-d_2)\alpha d_{LR}m >$$

$$TR_1 + TR_2 + Km + C_{12}TR_1 + C_{21}TR_2$$

Cancelling the identical terms:

$$d_{LR}TR_2 - (1-d_2)\alpha d_{LR}m + d_{LR}(C_{21}TR_2) > TR_2 + C_{12}TR_1 + C_{21}TR_2$$

$$d_{LR}TR_2 - (1-d_2)\alpha d_{LR}m - C_{12}TR_1 - (1-d_{LR})(C_{21}TR_2) > TR_2$$

This gives us the following results:

**Table 4.d.12: Effect of Complementarity on optimality depending on the sign of the switching variable; GRAD over BBN**

	Signed additional term	Optimality of GRAD over BBN
$C_{12}^{+}; C_{21}^{+}$	$-C_{12}^{+}TR_1^{+}-(1-d_{LR})^{+}(C_{21}^{+}TR_2^{-})$	Reduced
$C_{12}^{+}; C_{21}^{-}$	$-C_{12}^{+}TR_1^{+}-(1-d_{LR})^{+}(C_{21}^{-}TR_2^{-})$	Strongly reduced
$C_{12}^{-}; C_{21}^{+}$	$-C_{12}^{-}TR_1^{+}-(1-d_{LR})^{+}(C_{21}^{+}TR_2^{-})$	Strongly reinforced
$C_{12}^{-}; C_{21}^{-}$	$-C_{12}^{-}TR_1^{+}-(1-d_{LR})^{+}(C_{21}^{-}TR_2^{-})$	Reinforced

We can now use these results to summarise the effect of complementarity on the current optimality of each strategy:

**Table 4.d.13: Effect of complementarity on optimality of all different strategies**

	Optimality of BBN over BBL	Optimality of GRAD over BBL	Optimality of GRAD over BBN
$C_{12}^{+}; C_{21}^{+}$	small, indeterminate	reduced	reduced
$C_{12}^{+}; C_{21}^{-}$	small, reinforced	reduced	strongly reduced
$C_{12}^{-}; C_{21}^{+}$	small, reduced	reinforced	strongly reinforced
$C_{12}^{-}; C_{21}^{-}$	small, indeterminate	reinforced	reinforced

We can thus determine the effect of each possible combination of complementarities.

In the case of both switching variables being positive, indicating the reinforcement of the effect of both reforms, the case for Gradualism is weakened. As both reforms depend in their magnitude on each other, a Big Bang strategy becomes optimal for a larger range of parameter values. The



decision between Big Bang Now and Big Bang Later depends on the magnitude of each effect and is thus indeterminate.

If the effect of the first reform is reinforced while the second reform has a smaller effect, the Big Bang Now strategy becomes clearly optimal for a larger range of parameter values than both the Gradualism and the Big Bang Later strategy. The optimality of a gradual strategy is strongly reduced, making the case for a Big Bang Now strategy much stronger.

The opposite does, however, apply when considering a reduction in the magnitude of both reforms signified by a negative switching factor for the first reform and a positive switching factor for the second. Here, Gradualism clearly becomes the better strategy, both in comparison to Big Bang Later and to Big Bang Now. The Big Bang Now strategy also becomes less optimal in comparison to Big Bang Later - further strengthening the case for a more gradual approach.

Gradualism also becomes optimal for a larger range of parameter values when the effect of the second reform is increased, while the effect of the first reform is reduced. In this case the magnitude of the change is not quite as large but Gradualism still comes out as a clear favourite. The optimality of Big Bang Later compared to Big Bang Now is indeterminate, but due to the small scale of the effect, it is unlikely that Big Bang Later will be optimal for a larger range of parameter values, due to the likely size of the other variables, as discussed in the previous section.

This applies to all the results. Thus, Big Bang Later is unlikely to become the optimal strategy, due to complementarities. But the case does alter when Big Bang Now and Gradualism are considered. Here, the optimality depends mainly on the effect of the second reform on the pay-off of the first reform ( $C_{12}$ ). If the effect is positive, the case for Big Bang Now is reinforced, while a negative effect reinforces Gradualism. The effect of the first reform on the pay-off of the second reform ( $C_{21}$ ) only serves to reinforce or reduce this result.

Thus, complementarity plays a vital role in determining the optimal strategy of introducing reforms. If the reforms need to have complementary reforms introduced to be successful, the case for a Big Bang Now strategy is reinforced. This could be the case when considering the creation of a legal, economic and social framework, which might be necessary for any other reforms to be successful. If the effect of complementarity does, however, reduce the gains from the first, successful reforms, Gradualism is an optimal strategy for a larger range of parameter values. This might be the case when the introduction of reforms will create a great deal of uncertainty and unemployment in a number of sectors or possibly if a large degree of taxes have to be raised to introduce a particular reform.

To assess the effect of complementarities on political feasibility and optimality we can use the following table:

**Table 4.d.14: Effect of Complementarities on Political Feasibility and optimality of all strategies**

	$C_{12}^{+}; C_{21}^{+}$	$C_{12}^{+}; C_{21}^{-}$	$C_{12}^{-}; C_{21}^{+}$	$C_{12}^{-}; C_{21}^{-}$
Optimality of BBN over BBL	small, indeterminate	small, reinforced	small, reduced	small, indeterminate
Optimality of GRAD over BBL	reduced	reduced	reinforced	reinforced
Optimality of GRAD over BBN	reduced	strongly reduced	strongly reinforced	reinforced
Effect on Political Feasibility of BBN/BBL	indeterminate	reinforced	reduced	indeterminate
Effect on Political Feasibility of GRAD	reduced	reinforced	Reduced	reinforced

When interpreting the result of this table it is necessary to discuss, in turn, the case of each different combination of the direction of complementarities. The analysis will concentrate on the comparison of Gradualism to Big Bang Now, as the case for Big Bang Later is weak due to

the very low range of parameter values which could possibly make this strategy optimal.

When both switching variables have a positive sign, the case for Big Bang Now is strengthened, as the range of parameter values for which this strategy is optimal becomes larger, while the effect on Political Feasibility is indeterminate. Simultaneously, the possibility for Gradualism to be Political Feasible is reduced.

The case for Big Bang Now is also reinforced when the first switching variable is positive while the second one is negative. Here, the Political Feasibility of this strategy is also reinforced, but it is interesting to note that Gradualism also becomes Politically Feasible for a larger range of parameter values.

The situation is very different for the opposite direction of the complementarities. Here, Gradualism becomes optimal for a larger range of parameter values, while the Political Feasibility of Gradualism is reduced. But at the same time Big Bang Now also becomes less Politically Feasible.

When both switching variables are negative, the case for a Gradual strategy is unambiguously improved. The strategy becomes optimal and Politically Feasible for a larger range of parameter values, while the effect on Political Feasibility of Big Bang Now is indeterminate.

Thus the effect of complementarity is important for both Political Feasibility and optimality but one has to consider the effect of each particular reform to assess the degree and sign of the interaction to determine whether Gradualism or Big Bang Now is the better strategy.

## **Chapter 4: The Model**

### **e) Time Inconsistency**

The accession countries face a difficult process in which they have to maintain a political constituency for membership. They need to introduce a large number of reforms in light of the constraints they face. The introduction of reforms is reinforced by the EU's resolve to make pre-accession aid, and indeed accession itself, conditional on the fulfilment of an accession timetable of reforms:

"From 1998, reinforcement of the pre-accession strategy will be accompanied by a move to make the granting of European Union assistance, particularly financial assistance, to the applicant countries conditional upon their implementing the programmes aimed at preparing them to meet their obligations as future Member States" (Agenda 2000 - Volume II, Method, B).

As such, the applicants have to introduce a number of reforms over the next few years, while maintaining or creating political and economic stability. A number of reforms are needed in all the applicant countries, with some having made more progress than others have. Even the Commission acknowledges that the

"Assessments of the cost of the applicant countries' adoption of the whole Community acquis ... show that it will be very considerable everywhere" (Agenda 2000 - Volume II, III).

An accession strategy must allow these countries to prepare for a later accession in an optimal way, while taking certain constraints into account. The applicants can choose to introduce all the reforms immediately (Big Bang Now, BBN), they can introduce reforms consecutively (Gradualism, GRAD) or they can choose to introduce reforms at the latest possible date (Big Bang Later, BBL). This section establishes a theoretical basis for pursuing a given strategy, on the basis of the Time Inconsistency constraints these countries face.

In particular, this section deals with the problem of commitment, which will have important consequences for the benefits from any strategy. The Time Inconsistency problem arises when a government has the possibility to relinquish an earlier promise. In this particular case, the government can decide to announce an accession strategy and then introduce the reforms at a different stage than was announced previously. This results in a surprise reaction of the economy, which expected the announced reforms and adjusted accordingly. If the economic agents have perfect foresight they will adjust to this development and adjust to the expected outcome. The government has, however, the advantage of moving later in the game and can thus attempt to cheat on the expected strategy. The problem of Time Inconsistency was highlighted in connection to the conduct of monetary policy by authors such as Barro and Gordon (1983). The wider application of Time Inconsistency to government policy is based on pioneering work done by Persson and Tabellini (1992, 1994 and 1997).

Thus, there is a need to analyse which reform strategies are likely to be time consistent and which face a serious problem to follow a pre-announced time path. The analysis shows that all accession strategies face problems of Time Inconsistency, which can only be solved when introducing punishment by an outside agency, which in this case is the European Union. This punishment can take the form of making pre-accession aid contingent upon the fulfilment of a reform timetable, which is, indeed, the approach suggested by the Commission in Agenda 2000. This would be further reinforced by the signal function of any such aid to private investors. The granting of reform contingent aid could signal progress and thus attract a higher level of FDI. Gradualism can be the optimal strategy but it can only be implemented when accompanied by a sufficient punishment by the European Union, contingent upon the fulfilment of a pre-announced timetable of reforms.

It should be noted that there are other potential possibilities for an accession country to pre-commit to a particular accession strategy. In particular, the government can commit by staking its own future on the

success of an accession strategy within the internal political arena. This is similar to the reputation and credibility effects highlighted in connection to monetary policy (See, for example, Backus & Driffil, 1985). However, in part there will remain a large potential for Time Inconsistency in the accession process as governments can attempt to utilise the inherent uncertainty of transition. One of the most credible commitment mechanisms will be a personal commitment by influential actors in the accession process. If a commitment is based on personal belief, as has been the case for some of the actors in CEE, it can be potentially credible. Furthermore, for certain policies there is the possibility to delegate policies to an independent agency, similar to an independent central bank. This has been done, for example, in relation to privatisation, notably in Germany where the Treuhandanstalt was established to privatise the state-owned industries of East Germany. This is similar to delegating monetary policy to an independent central bank, where in general the positive effects created by credibility outweigh the problem of inflexible policy (See for example the discussion by Rogoff (1985) and Lohmann (1992)). However, the accession process is a multi-subject process at the heart of the legislative powers of the state. Thus, delegation of the process as a whole is not feasible without undermining the democratic fabric of the CEECs. The Time Inconsistency described in this section focuses on the interaction between the EU and the CEECs, in particular the role of transfers. The theoretical discussion does not claim to cover all aspects of Time Inconsistency. Rather, it attempts to capture a crucial aspect of the accession process - the attempt to commit to a strategy for an uncertain accession process, taking into account the influence which the EU can have on this constraint.

To discuss all possible strategies, we need to establish the benefits and costs of each. Thus, to define the optimal strategy we have to calculate the following equations:

$$\Sigma BBN^t = \Sigma GBBN^t + \Sigma LBBN^t$$

$$\Sigma \text{BBN}^f = \Sigma \text{GBBN}^f + \Sigma \text{LBBN}^f$$

$$\Sigma \text{BBL}^t = \Sigma \text{GBBL}^t + \Sigma \text{LBBL}^t$$

$$\Sigma \text{BBL}^f = \Sigma \text{GBBL}^f + \Sigma \text{LBBL}^f$$

$$\Sigma \text{GRAD}^t = \Sigma \text{GGRAD}^t + \Sigma \text{LGRAD}^t$$

$$\Sigma \text{GRAD}^f = \Sigma \text{GGRAD}^f + \Sigma \text{LGRAD}^f$$

Here, the sum of all strategies is expressed in terms of benefits (B) and losses (L). The superscript t stands for a "true" strategy where the announcements are fulfilled, while superscript f stands for a "false" strategy, involving the relinquishing of a promise. This means a reform is announced and then not actually carried out at the pre-announced time. In the case of BBN and GRAD, an announced reform is not put into place until a later date, while BBL involves introducing a reform before it is expected.

We will first demonstrate which strategy will be chosen when time consistency is not taken into account. The government tries to maximise the benefit of accession by choosing the accession strategy, which will produce, on balance, the greatest gain. The gains are the benefits of each event suitably discounted, while the losses come about by deferring strategies to a later point in time. The following table shows the benefits and losses for each strategy, discounted according to the period in which they occur. This table is taken from the previous section and will be applied to the problem of Time Inconsistency, later on in this section.

**Table 4.e.1: Pay-off table for all strategies**

	Reform 1	Reform 2	membership	Loss of waiting
BBN <sup>t</sup>	R <sub>1</sub>	R <sub>2</sub>	K <sub>m</sub>	0
BBL <sup>t</sup>	d <sub>LR</sub> R <sub>1</sub>	D <sub>LR</sub> R <sub>2</sub>	K <sub>m</sub>	-(1-d <sub>1</sub> d <sub>2</sub> )αd <sub>LR</sub> m
GRAD <sup>t</sup>	R <sub>1</sub>	D <sub>LR</sub> R <sub>2</sub>	K <sub>m</sub>	-(1-d <sub>2</sub> )αd <sub>LR</sub> m



There are three time periods, the Short Run (SR), the Long Run (LR) and Membership (M), with associated time discount factors  $d_{SR}=1$ ,  $d_{LR}$  and  $d_M$ . These discount factors take a value between 0 and 1 and a low discount factor signifies a high degree of future discounting or "impatience". There are three events: Reform 1, Reform 2 and Membership. Reform 1 and Reform 2 are associated with dummy discount factors ( $d_1$  and  $d_2$ ). Prior benefits from Membership ( $\alpha_m$ ) become available in the short and long run, depending on which reforms are in place. Membership is expected, so a discounted benefit also accrues ( $d_M m$ ).

Benefits, which all strategies have in common, are summarised by  $K_m$  ( $K_m = F\{d_1, d_2, \alpha, d_{LR}, d_M, m\}$ ). A delay of reform will result in a loss from waiting, which depends on whether one (GRAD) or both (BBL) reforms are delayed ( $-(1-d_2)\alpha d_{LR} m$  and  $-(1-d_1 d_2)\alpha d_{LR} m$ , respectively). The total effect of Reform 1 (R1) is **assumed** to be positive, whereas the total effect of Reform 2 (R2) is **assumed** to be negative. These two assumptions are designed to simplify the analysis. If the second reform is positive, deferring until the future is unnecessary as it only means that the benefit will be discounted. GRAD and BBL do not, however, necessarily follow from a negative second reform, as the postponement will result in some costs.

We can now establish the following identities:

$$\sum BBN^t = R_1 + R_2 + K_m$$

$$\sum BBL^t = d_{LR} R_1 + d_{LR} R_2 + K_m - (1-d_1 d_2)\alpha d_{LR} m$$

$$\sum GRAD^t = R_1 + d_{LR} R_2 + K_m - (1-d_2)\alpha d_{LR} m$$

We need to distinguish between the effect of announced and fulfilled expectations to address the question of Time Inconsistency. The variables affecting this constraint are given by the relationships:

$$-\gamma_1(R_{1a} - R_1) \text{ and } \gamma_2(R_{2a} - R_2)$$

$R_{1a}$  and  $R_{2a}$  take the value  $R_1$  and  $R_2$  respectively when the associated reform is fulfilled, while they take the value 0 when the expectation is not fulfilled.  $R_1$  and  $R_2$  are the total effects of Reform 1 and Reform 2 respectively, where the second reform is assumed to be negative. This means there is a positive benefit from announcing a reform, which is then not fulfilled. The benefit from “cheating” will only occur in preparation for the reform. Thus, a reform, which is carried out earlier than expected, will not yield this benefit.<sup>81</sup> The following table shows the sequencing of reforms under each true and false strategy.

**Table 4.e.2: Difference between true and false strategies.**

	SR	LR
GRAD <sup>t</sup>	$R_1$	$R_2$
GRAD <sup>f</sup>	$\gamma_1 R_1$	$R_1, R_2$
BBN <sup>t</sup>	$R_1, R_2$	
BBN <sup>f</sup>	$R_1$ $-\gamma_2 R_2$	$R_2$
BBL <sup>t</sup>		$R_1, R_2$
BBL <sup>f</sup>	$R_1$	$R_2$

For GRAD<sup>f</sup> one could also choose to introduce  $R_1$  and  $R_2$  in the first period. This, however, would be exactly equivalent to BBN<sup>t</sup>, which is dominated by GRAD<sup>t</sup>, as demonstrated previously.

The cheating for BBL could also take the form of introducing BBN, but as GRAD is optimal, as shown earlier, it is better to introduce an unexpected Gradual strategy. For BBL<sup>f</sup> one could also choose to introduce  $R_1$  and  $R_2$  in the first period. This, however, would be exactly equivalent to BBN<sup>t</sup>, which has been shown to be dominated by GRAD<sup>t</sup>. There are no surprise benefits, as the expectation is for a later introduction, with no adjustments taking place.

<sup>81</sup> Even if the possibility of this kind of benefit is included, the relative punishments of the different strategies are unaltered. BBL would then need to be punished by  $\Delta = \beta + \gamma_1$ .

Similarly, the BBN strategy involves emulating the gradual strategy while trying to cash in on changed expectations. Thus, only the second reform is postponed. BBN<sup>f</sup> is more complex. It would involve introducing both reforms in the second period. This would realise both surprise benefits for both reforms in the first period. Thus the following condition needs to be satisfied to determine that the false strategy dominates any other false strategy:

$$R_1>d_LR_1+\gamma_1R_1-(\text{additional loss from the postponement})$$

This turns out to be:

$$R_1>d_LR_1+\gamma_1R_1-d_2(1-d_1)\alpha m$$

or

$$R_1/m>(d_L+\gamma_1)R_1/m-d_2(1-d_1)\alpha$$

This condition holds in general, which is demonstrated in the numerical example, introduced later on in this section<sup>82</sup>.

Thus, we can show the benefits and losses of each strategy, excluding those benefits and costs which all strategies have in common.

**Table 4.e.3: All benefits and losses of the different strategies.**

	BBN <sup>t</sup>	BBN <sup>f</sup>	GRAD <sup>t</sup>	GRAD <sup>f</sup>	BBL <sup>t</sup>	BBL <sup>f</sup>
loss of waiting (LR)	✖	-(1-d <sub>2</sub> ) αm	-(1-d <sub>2</sub> ) αm	-(1-d <sub>1</sub> d <sub>2</sub> ) αm	-(1-d <sub>1</sub> d <sub>2</sub> ) αm	-(1-d <sub>2</sub> ) αm
Reforms (SR)	R <sub>1</sub> R <sub>2</sub>	R <sub>1</sub>	R <sub>1</sub>	✖	✖	R <sub>1</sub>
Reforms (LR)	✖	R <sub>2</sub>	R <sub>2</sub>	R <sub>1</sub> R <sub>2</sub>	R <sub>1</sub> R <sub>2</sub>	R <sub>2</sub>
Surprise function (SR)	✖	-γ <sub>2</sub> R <sub>2</sub>	✖	γ <sub>1</sub> R <sub>1</sub>	✖	✖

We can, therefore, establish the identities for the "false" strategies:

<sup>82</sup> Example 1: 0.1>0.13-0.036, Example 2: 0.02>0.016-0.009 (for parameter values, see p. 213)

$$\Sigma BBN^f = R_1 + d_{LR}R_2 + K_m - (1-d_2)\alpha d_{LR}m - \gamma_2 R_2$$

$$\Sigma BBL^f = R_1 + d_{LR}R_2 + K_m - (1-d_2)\alpha d_{LR}m$$

$$\Sigma GRAD^f = d_{LR}R_1 + d_{LR}R_2 + K_m - (1-d_1d_2)\alpha d_{LR}m + \gamma_1 R_1$$

The actual parameter values in this surprise function vary from reform to reform. Due to the breadth of reforms required by the EU, the functional form needs to be suitably general to incorporate any possible benefit from relinquishing an earlier promise. The general form means that any benefit from “cheating” which is positive can be taken into account. This can, for example, take the form of an inflationary bias, as the EU requires the full liberalisation of trade and prices, while pressing for stable prices as well. Governments might be tempted to let inflation run higher than expected for a while, to cushion the contractionary effect these liberalisations can have. It could also take the more general form of encouraging FDI by establishing a reputation as an early entry candidate and, once the investment has occurred, slowing down the pace of transformation. A further example would be the announcement of strict budget controls on state firms. This would lead to a drive towards more efficiency, as well as encouraging mobile workers to move. Once this has happened, it might not be in the interest of the state to close those factories, which have not met the strict constraint, as these are often large industries with a substantial amount of non-mobile workers. Thus, there are various examples of Time Inconsistent reform announcements in the accession process. If those concerned and the markets realise that a strategy is Time Inconsistent, they will try to adjust to a strategy which they judge to be realistic. It can, however, be the case that any accession strategy is judged to be Time Inconsistent. An example might be when a government acts contrary to any guideline of the EU, while still maintaining that they want to be a member in the near future, which arguably has been the case for Slovakia. Thus, the issue of time consistency is crucial in determining whether a

strategy will actually be carried out or whether it is announced to reap the benefits without intending to actually pay the price.

Gradualism will be Time Inconsistent if the benefit from the true strategy is outweighed by the false strategy, i.e. if, and only if:

$$\Sigma \text{GRAD}^f > \Sigma \text{GRAD}^t$$

We can now introduce the identities, which have been defined previously:

$$\begin{aligned} d_{LR}R_1 + d_{LR}R_2 - (1-d_1d_2)\alpha d_{LRm} + \gamma_1 R_1 &> R_1 + d_{LR}R_2 - (1-d_2)\alpha d_{LRm} \\ d_{LR}R_1 + \gamma_1 R_1 - R_1 &> -(1-d_2)\alpha d_{LRm} + (1-d_1d_2)\alpha d_{LRm} \\ (d_{LR} + \gamma_1 - 1)R_1 &> -d_2\alpha d_{LRm} - d_1d_2\alpha d_{LRm} \\ (d_{LR} + \gamma_1 - 1)R_1 &> -(1+d_1)d_2\alpha d_{LRm} \end{aligned}$$

The RHS of this equation is negative, provided the long run discount factor and the gain from cheating are together larger than 1, this condition has to be fulfilled. It is thus likely that GRAD is Time Inconsistent. We then need to examine the other two strategies to see whether they are Time Inconsistent, even though they are not optimal<sup>83</sup>.

Big Bang Now will be Time Inconsistent if the benefit from the true strategy is outweighed by the false strategy.

BBN<sup>t</sup> is time consistent if, and only if,

$$\begin{aligned} \Sigma \text{BBN}^f &> \Sigma \text{BBN}^t \\ R_1 + d_{LR}R_2 - (1-d_2)\alpha d_{LRm} - \gamma_2 R_1 &> R_1 + R_2 \\ d_{LR}R_2 - (1-d_2)\alpha d_{LRm} - \gamma_2 R_2 &> R_2 \\ -(1+\gamma_2 - d_{LR})R_2 &> (1-d_2)\alpha d_{LRm} \end{aligned}$$

The RHS is positive, but relatively small. The RHS must be positive as the discount factor is smaller than 1. It will be relatively large as the discounting

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<sup>83</sup> GRAD is not optimal when directly compared to the "false" strategies. This hinges crucially on the surprise reaction of economic agents. These strategies are however not feasible, as the economic agents in the economy will foresee this temptation and thus will not react accordingly.

is outweighed by the additional effect of cheating. Thus, BBN is also Time Inconsistent, which leaves BBL as the only alternative.

Big Bang Later will be time inconsistent if the benefit from the true strategy is outweighed by the false strategy, i.e. if, and only if:

$$\begin{aligned}\Sigma BBL^f &> \Sigma BBL^t \\ R_1 + d_{LR}R_2 - (1-d_2)\alpha d_{LRm} &> d_{LR}R_1 + d_{LR}R_2 - (1-d_1d_2)\alpha d_{LRm} \\ R_1 - (1-d_2)\alpha d_{LRm} &> d_{LR}R_1 - (1-d_1d_2)\alpha d_{LRm} \\ R_1 - d_{LR}R_1 &> -(1-d_1d_2)\alpha d_{LRm} + (1-d_2)\alpha d_{LRm} \\ (1-d_{LR})R_1 &> d_1d_2\alpha d_{LRm} - d_2\alpha d_{LRm} \\ (1-d_{LR})R_1 &> -(1-d_1)d_2\alpha d_{LRm}\end{aligned}$$

As the RHS is positive and the LHS is negative, this demonstrates that BBL is always Time Inconsistent under the circumstances modelled in this framework.

Thus this analysis shows that *all accession strategies are Time Inconsistent*. This could mean that accession itself becomes doubtful if there are reforms, which are seen as a necessary condition. Thus, it is necessary for an outside agency to enforce a time consistent strategy by introducing a punishment, the effect of which will be shown in the next section.

To address this problem of Time Inconsistency, it is necessary to transfer some control to an outside agency. In this case the EU has an interest in enforcing a time consistent strategy by making pre-accession aid contingent upon the fulfilment of a pre-announced timetable. The EU is a credible enforcer as it is in the EU's self-interest to enforce a credible strategy and the punishment mechanism exists in the form of pre-accession transfers<sup>84</sup>. In this model there will be a parameter  $\beta$ , which is set by the EU. This will result in a punishment of  $-\beta_1R_1$  and  $\beta_2R_2$  if either reform is announced but put into

place at a different time. As this cheating is apparent in the short run, this punishment does not need to be discounted. We can introduce this punishment into the identities:

$$\begin{aligned}\Sigma \text{BBN}^f &= R_1 + d_{LR}R_2 + Km - (1-d_2)\alpha d_{LR}m - \gamma_2 R_2 + \beta_2 R_2 \\ \Sigma \text{BBL}^f &= R_1 + d_{LR}R_2 + Km - (1-d_2)\alpha d_{LR}m - \beta_1 R_1 \\ \Sigma \text{GRAD}^f &= d_{LR}R_1 + d_{LR}R_2 + Km - (1-d_1d_2)\alpha d_{LR}m + \gamma_1 R_1 - \beta_1 R_1\end{aligned}$$

To analyse the effect, we will introduce the punishment into time consistency conditions and then solve for the punishment parameter. Note that the greater sign has been switched for an equality as now it is establishing a necessary and sufficient condition for time consistency.

For GRAD we get:

$$\begin{aligned}(d_{LR} + \gamma_1 - 1)R_1 - \beta_1 R_1 &= -(1+d_1)d_2\alpha d_{LR}m \\ (d_{LR} + \gamma_1 - 1)R_1 + (1+d_1)d_2\alpha d_{LR}m &= \beta_1 R_1 \\ \beta_1 &= d_{LR} + \gamma_1 - 1 + (1+d_1)d_2\alpha d_{LR}(m/R_1)\end{aligned}$$

For BBN we get the following time consistency condition:

$$\begin{aligned}-(1+\gamma_2 - d_{LR})R_2 + \beta_2 R_2 &= (1-d_2)\alpha d_{LR}m \\ \beta_2 &= (1-d_2)\alpha d_{LR}(m/R_2) + 1 + \gamma_2 - d_{LR}\end{aligned}$$

And finally for BBL:

$$(1-d_{LR})R_1 - \beta_1 R_1 = -(1-d_1)d_2\alpha d_{LR}m$$

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<sup>84</sup> The EU could further enforce time consistency by operating a clearinghouse by which a fixed sum of transfers is distributed to all accession candidates according to the progress they have made. This would mean that they would also have to compete against each other to obtain these funds.



$$\beta_1=(1-d_1)d_2\alpha d_{LR}(m/R_1)+1-d_{LR}$$

These values are difficult to evaluate. But running through two short numerical examples will help to underline their significance

(where  $\beta_1=\beta_2$ ).

Example 1:

$$d_{LR}=d_1=d_2=0.9$$

$$\alpha=\gamma_1=\gamma_2=0.4$$

$$(m/R_1)=-(m/R_2)=10$$

$$\text{GRAD}^{85}: \quad \beta=0.9+0.4-1+(1+0.9)0.9*0.4*0.9*10=0.3+6.156=6.456$$

$$\text{BBN}: \quad \beta=(1-0.9)0.4*0.9(-10)+1+0.4-0.9=0.5-0.36=0.14$$

$$\text{BBL}: \quad \beta=(1-0.9)0.9*0.4*0.9*10+1-0.9=0.1+0.324=0.424$$

Example 2:

$$d_{LR}=0.7$$

$$d_1=d_2=0.9$$

$$\alpha=\gamma_1=\gamma_2=0.1$$

$$(m/R_1)=-(m/R_2)=50$$

$$\text{GRAD}^{86}: \quad \beta=0.7+0.1-1+(1+0.9)0.9*0.1*0.7*50=-0.2+5.985=5.785$$

$$\text{BBN}: \quad \beta=(1-0.9)0.1*0.7(-50)+1+0.1-0.7=0.4-0.35=0.05$$

$$\text{BBL}: \quad \beta=(1-0.9)0.9*0.1*0.7*50+1-0.7=0.3+0.315=0.615$$

One can see that GRAD needs a substantial punishment to be enforced, which turns out in most cases to be a multiple of the actual reform benefits or losses. BBN needs the least amount of enforcement and BBL is somewhere in between. Thus, to enforce the optimal strategy of Gradualism, the European Union has to make a substantial amount of pre-accession aid contingent upon the fulfilment of reforms. If the EU would want to enforce either BBN or BBL,

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<sup>85</sup> GRAD is optimal, as demonstrated earlier.

a smaller amount of punishment would be necessary. These strategies are, however, not optimal and even here some punishment is needed to ensure that these strategies are time consistent.

This analysis supports the basic premise of the Commission, which is recognised in Agenda 2000:

"In most cases, a gradual process of adaptation of candidate countries to the acquis would appear to be the only realistic path, given the complex character of the process, its costs, and the need to alleviate related adjustment strains. The bulk of this effort should be deployed during the period leading to accession, when progress could also be linked to the further gradual opening of the Community markets" (Agenda 2000- Volume II, Part III: Conclusions, 7).

The analysis has however shown that all accession strategies are Time Inconsistent. This has very important implications for the accession process. In particular, it is necessary to assess whether the process includes a strong incentive for applicants to keep to their announced accession strategies. This has been taken into account by the European Union, which makes the accession and pre-accession aid conditional after 1998, thus creating an effective punishment mechanism. The European Union does, however, need to make sure that this gradual accession strategy is actually backed up by a substantial and credible punishment schedule, as otherwise, Gradualism might turn out to be Time Inconsistent, while a sub-optimal process, such as BBN or BBL, might not be.

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<sup>86</sup> GRAD is optimal, as demonstrated earlier.

## Chapter 4: The Model

### f) Uncertainty

Uncertainty has been a notable problem in transition economies since the revolutions of 1989 and 1990 swept the old system from power:

“Communism’s demise destroyed the political barriers dividing Europe and shattered Eastern European economic structures including trade agreements. Integration and reconstruction are under way, but the outcome is still uncertain” (Baldwin, 1994, p. xv).

The Uncertainty concerns not only the structure of the Eastern European countries but also their relationship with the EU. Richard Portes states an example among many:

“Political and economic uncertainty will severely restrict our direct investment there [Central and Eastern Europe] for a considerable period” (1993, p. 13).

In a sense the whole field of transition economics developed in response to the uncertainties involved in changing a formerly planned economy with an authoritarian government, to a market economy with a democratic government.

We will begin by modelling the choice of the Central or Eastern European (denoted by EE) applicant country. It is important to note that the modelling in this section uses linear welfare functions. As a result, the resulting solutions are often boundary or corner solutions. While a linear welfare function does not capture all the complexities of the accession process, it is nevertheless sufficient for the purpose of this model, namely to determine the interaction between the choice of the CEECs and the choice of the EU. The welfare function is initially linear in the choice variable, as endogenised Uncertainty is only introduced in the next section. The resulting analysis can, thus, not determine the optimal choice of the applicant. Rather the solutions to the equations determine the boundaries of the problem.

Welfare, in a world without uncertainty, will be defined by the following equation:

$$WEE = dR + dM + \lambda M + (1-d)(1-\sigma)R$$

Where  $R$  is the sum of reform benefit and losses,  $M$  is the discounted benefit from joining the EU and  $\lambda M$  represents a transfer from the EU to the applicant country. The reforms  $R$  are a necessary condition to join the EU and the benefits and losses associated with membership will only occur when the reforms actually take place. If the reforms take place, the dummy  $d$  will take the value 1, while it will be 0 when the reforms do not occur.  $(1-\sigma)R$  is a surprise variable, where  $\sigma$  ( $\sigma \geq 0$ )<sup>87</sup> is a choice variable of the applicant country.  $R$  and  $M$  are dependent upon the reforms being introduced, otherwise they all take the value 0.  $\lambda$  ( $\lambda \geq 0$ )<sup>88</sup> is the choice variable of the EU representing a transfer factor while  $\sigma$  is the choice variable of the applicant representing a surprise policy decision for the economy. The surprise to the economy as a whole comes from the government deciding to change policy after adjustments by the economy as a whole have taken place. Consequently, the government is tempted to announce policy and then to change direction to benefit from adjustments without incurring the actual cost of the policy.

The reforms will be initiated if the benefits from doing so are larger than the benefits of cancelling the reforms. Thus:

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<sup>87</sup> The bounding of the variable ensures that the applicant country cannot derive more benefit from “cheating” than  $R$ . The applicant can however credibly commit by, for example, entering financial agreements which could ensure a value higher than 1, which suggests a loss, rather than gain, being associated with no reforms.

<sup>88</sup> The bounding ensures that the EU cannot extract transfers from the applicant. At the extreme, the EU will transfer nothing while it can either transfer a fraction or a multiple of the benefits from membership of the CEEC prior to accession.

$$R + M + \lambda M \geq \lambda M + (1-\sigma)R$$

$$R + M \geq (1-\sigma)R$$

$$M \geq -\sigma R$$

$$\sigma \geq -M/R$$

This boundary shows under which circumstances the introduction of reforms will be beneficial to the applicant. Only if the surprise variable is substantially negative will there be a benefit from not introducing the reforms. As the surprise variable is bounded to be positive ( $\sigma \geq 0$ ), reforms will always be more beneficial than no reforms.

We will now turn to the choice of the European Union (EU). The welfare function is given by:

$$WEU = dfM - \lambda M$$

Welfare for the EU, in a world without uncertainty, in case reforms take place, will be determined by the following equation:

$$WEU = fM - \lambda M$$

While no reforms yield the following result:

$$WEU = -\lambda M$$

The factor  $f$  ( $f \geq 0$ )<sup>89</sup> represents a weighting on the benefits of the CEECs which reflects the benefits for the EU as a whole. The reforms will be initiated as long as the benefits from doing so are larger than the benefit of cancelling the reforms. Thus:

$$fM - \lambda M \geq -\lambda M$$

Thus:

$$fM \geq 0$$

Thus, for the EU, the introduction of the reforms in the CEEC will be more beneficial than the cancellation of reforms as long as there are positive total benefits for the EU associated with membership. This is independent of the transfer variable but a 0 transfer clearly maximises the functions as long as membership is beneficial. However, for the EU to engage in the process, membership has to be ensured to obtain any benefits. Furthermore, even if membership happens,  $f \geq \lambda$  has to be fulfilled to obtain positive benefits for the EU. This point is discussed in detail, later. It has to be noted that other benefits could accrue in the run up to accession, for example gains from trade. However, the benefits identified here relate directly to the accession process. Trade will take place whether accession takes place or not and thus will not influence the negotiation position of the EU.

Combined welfare ( $W1$ ), in case the reforms happen, is thus determined by:

$$W1 = R + M + \lambda M + fM - \lambda M$$

$$W1 = R + (1 + f)M$$

In case the reforms do not happen, the combined welfare function ( $W2$ ) is:

$$W2 = \lambda M + (1 - \sigma)R - \lambda M$$

$$W2 = R - \sigma R$$

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<sup>89</sup> The variable is bounded above 0 to ensure positive benefits of the EU from membership of an applicant country. This can represent economic as well as political benefits and arguably it is the reason

Reforms will be beneficial if the combined welfare associated with the reforms is larger than the combined welfare associated with no reforms. This will be true as long as the following equation is satisfied:

$$\begin{aligned} W1 &\geq W2 \\ R + (1 + f)M &\geq R - \sigma R \\ (1 + f)M &\geq - \sigma R \\ \sigma &\geq - (1+f)M/R \end{aligned}$$

Thus the only circumstance under which the reforms are less beneficial than no reforms is a very large positive effect occurring when the reforms do not take place. As the variable is bounded, in this simple case reforms will always be better than no reforms.

We will now introduce uncertainty ( $\alpha$ ) into this model.  $\alpha$  is the probability that a reform happens while  $(1-\alpha)$  is the probability that the reform fails. In this section, this probability is determined by exogenous factors. In the next section of this chapter we will incorporate the choices of the economic agents and their influence on overall success or failure of the reform process. However, in the case of factors exogenous to the model determining Uncertainty, we can see that the general welfare functions are:

$$\begin{aligned} WEE &= \alpha[ R + M + \lambda M] + (1-\alpha)[\lambda M + (1-\sigma)R] \\ WEE &= \alpha R + \alpha M + \alpha \lambda M - \alpha \lambda M - \alpha(1-\sigma)R + \lambda M + (1-\sigma)R \\ WEE &= \alpha R + \alpha M - \alpha R + \alpha \sigma R + \lambda M + R - \sigma R \\ WEE &= R + \alpha M + \alpha \sigma R + \lambda M - \sigma R \end{aligned}$$

From this welfare function for the Eastern European applicant we can see that the only negative term is related to the surprise variable, which is in part offset by the same term, reduced by the uncertainty factor. Thus, a low

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the EU will accept any new member in the first place.



surprise value will increase welfare. In addition, the positive benefit from membership is reinforced by the transfers from the EU.

Similarly, we can now establish the welfare function of the EU under uncertainty.

$$\begin{aligned} WEU &= \alpha[fM - \lambda M] - (1-\alpha)\lambda M \\ WEU &= \alpha fM - \alpha \lambda M - \lambda M + \alpha \lambda M \\ WEU &= \alpha fM - \lambda M \end{aligned}$$

A positive  $M$  will yield a positive welfare when  $f$  is larger than  $\lambda$  if there is no uncertainty, while welfare is negative when the reverse applies. If this condition is applied and as long as welfare is positive, no uncertainty will maximise the welfare function. We can assume that the EU would not get involved in the process when this results in a negative welfare for the EU. Thus, we will assume that the benefits to the EU will be positive in further discussions. This means that  $f$  must be larger than the transfer variable.

Differentiating both functions with respect to the choice variables determines the boundary condition for the welfare functions. Beginning with the applicant country:

$$dWEE/d\sigma = \alpha R - R = (1-\alpha)(-R)$$

The boundary value for the welfare function turns out to be at the value when reforms take place with certainty, i.e.  $\alpha = 1$ . At this point the effect on the surprise variable is indeterminate. For any other positive probability of reform happening, as given by the bounds, a low surprise factor, i.e. high surprise effect, will maximise the applicant's welfare as long as the reform has a positive outcome.

We will now determine the boundary condition for the EU:

$$dWEU/d\lambda = -M$$

The border solution of the welfare function for the EU is given by  $WEU = -M$ . If  $M$  is positive, maximum welfare implies that  $\lambda = 0$ , i.e. that no transfers take place. The corner solution occurs when  $M = 0$ , when transfers are indeterminate. As explained before, we assume that  $M$  is positive. This would imply that no transfers are optimal, which is not surprising, given that in the model in this section transfers can not be used to enforce a positive outcome for the EU as there is no conditionality attached to the transfers.

If we now combine the welfare functions, we get the following result:

$$W = R + \alpha M + \alpha \sigma R + \lambda M - \sigma R + \alpha f M - \lambda M$$

$$W = R + \alpha M + \alpha \sigma R - \sigma R + \alpha f M$$

Maximising combined welfare, we get the same result as when maximising the welfare of the applicant country. Namely, for any positive probability of reform happening with the exception of the corner selection when reforms happen with certainty, a low surprise factor, i.e. high surprise effect, will maximise the applicant's welfare as long as the reform has a positive outcome. However, Uncertainty is crucially influenced by the behaviour of the economic agents, the EU and the applicant. The next section will thus incorporate the influence of the agents' behaviour on overall Uncertainty. In other words, the decision of the economic agents will be endogenised.

## Chapter 4: The Model

### g) Endogenised Choices

Building on the previous section, we will now endogenise the decisions of both players. The previous section assumes that the probability of reform success is determined by exogenous factors. However, realistically the behaviour of the economic agents, the applicant and the EU, will affect the outcome. In this section, it will be shown how aggregate Uncertainty in the accession process is related to transfer payments from the EU and to unanticipated policy changes. For this purpose, the model introduced in previous sections will be extended to endogenise the probability of reforms, and membership. Two players, the EU and one applicant country, will determine a choice variable each, which will impact on each other. The EU chooses to set a transfer payment while the applicant country can choose to create an unanticipated policy change, which by itself would be welfare enhancing. The decisions of both players will impact on aggregate uncertainty. Namely a high transfer and a low policy surprise value will increase the probability of a reform taking place. A higher surprise value  $(1-\sigma)R$  will thus increase the chance of reforms not taking place. Similarly, a higher transfer  $\lambda M$  will increase the chance of reforms taking place. Thus a high  $\lambda$  and a high  $\sigma$  will increase the probability of reforms taking place, while a low  $\lambda$  and a low  $\sigma$  decrease the probability of reforms taking place.

In this section, the difference in definition between aggregate and residual uncertainty is important to bear in mind. While either the EU or the CEECs cannot influence residual uncertainty, aggregate uncertainty depends on policy choices made by these actors. Aggregate uncertainty is the level of uncertainty for the actors in the economy as a whole, while the CEECs and the EU can, in part, trade off their choices against each other's choice and residual uncertainty. The remaining economic actors have to take aggregate

uncertainty as a given. Aggregate uncertainty is thus a combination of residual uncertainty and the choice of the EU in terms of transfers, as well as the choice of the CEEC to relinquish on a pre-announced accession strategy.

This will be endogenised in the model and a reaction function for both players will be derived. Included in this will be a residual level of uncertainty, which will be important in the later analysis. The equilibrium in the model will occur when both players incorporate each other's reaction functions. Thus an equilibrium value of the surprise variable, as well as an equilibrium level of transfer payments, can be derived.

Due to the complexity of the results, the equilibrium levels are analysed by using a numerical simulation. The numerical simulation will also be used to make welfare comparisons. This simulation shows that transfer payments and the surprise variable, as well as residual uncertainty, will determine the level of aggregate uncertainty. Furthermore, it shows that variables such as the value of reforms itself, the benefit of membership and the differential of accession benefits between the EU and the applicant country, all influence the outcome and will have differing effects on different variables. The analysis covers a situation in which the reforms are costly as well as one in which the transfer payments are conditional on the success of reforms. The introduction of aggregate Uncertainty in this section results in the welfare functions becoming quadratic and an optimal choice for the applicant and the EU can be derived.

To capture this effect we will use the following equation to calculate the probability that reforms take place:

$$\begin{aligned}\chi &= \lambda\sigma\beta \\ \text{and} \\ (1-\chi) &= (1-\lambda\sigma\beta)\end{aligned}$$

where  $\beta$  is a residual probability that the reforms take place ( $1 \geq \beta \geq 0$ ). This can be seen as a probability influenced by outside factors such as the global

economic climate, the economic climate within the applicant country and the political processes which might influence the decisions of the applicant countries.

Given that the choice variables are part of aggregate uncertainty, the formula introduced above will be reintroduced into the welfare functions of the applicants. This expands the current linear welfare functions and they become quadratic in the choice variable. Thus, the optimal choices of the CEECs and the EU can be obtained by differentiating the welfare functions and then setting the derived reaction functions against each other.

As before, the boundaries of the choice variables are given by:

$$\lambda \geq 0 \text{ and } \sigma \geq 0$$

This means that there will always be a positive probability associated with reforms taking place. There can however be 'overkill', i.e. a  $\chi$  larger than 1. This will occur when both players try to overcompensate for the possibility of reforms not taking place. Here, reforms will happen with certainty, i.e.  $\chi = 1$ .

We will begin with the decision of the applicant country. The welfare function is given by

$$WEE = R + \chi M + \chi \sigma R + \lambda M - \sigma R$$

Substituting  $\chi = \lambda \sigma \beta$

$$WEE = R + (\lambda \sigma \beta) M + (\lambda \sigma \beta) \sigma R + \lambda M - \sigma R$$

$$WEE = R + \lambda \sigma \beta M + (\lambda \sigma^2 \beta) R + \lambda M - \sigma R$$

To determine the reaction function of the applicant country, we differentiate by  $\sigma$ .

$$dWEE/d\sigma = \lambda \beta M + 2\lambda \sigma \beta R - R = 0$$

$$\sigma (2\lambda \beta R) = -\lambda \beta M + R$$

$$\sigma = -M/(2R) + 1/2\lambda \beta$$

We can now explore the extreme cases. If the applicant country has the perception that there will be no EU transfers, the above equation takes an infinite value. Due to the boundaries this means that  $\sigma = 1$ , i.e. the policy surprise value becomes 0. The same result applies to a perceived residual probability of 0 of reforms not taking place. A high benefit of membership and a low value of reform increase the policy surprise value.

We will repeat the process for the EU. The welfare function is given by:

$$WEU = \chi fM - \lambda M$$

Substituting  $\chi = \lambda\sigma\beta$

$$WEU = \lambda\sigma\beta fM - \lambda M$$

To determine the reaction function of the EU we differentiate by  $\lambda$ .

$$dWEE/d\lambda = \sigma\beta fM - M = 0$$

$$\sigma = 1/\beta f$$

The same result as for the applicant applies to the residual uncertainty that reforms might not happen, whereas the effect of  $f$  will depend on whether  $f$  is a fraction or a multiple. We can now derive the equilibrium.

To determine the equilibrium solution for the equilibrium amount of transfers, we now put the separate solutions together:

$$\sigma = -M/(2R) + 1/2\lambda\beta$$

Substituting  $\sigma = 1/\beta f$

$$1/\beta f = -M/(2R) + 1/2\lambda\beta$$

$$2/\beta f = -M/R + 1/\lambda\beta$$

$$2\lambda/f + \lambda\beta M/R = 1$$

$$\lambda (2 + f\beta M/R) = f$$

$$\lambda = fR/(2R + f\beta M)$$

We can see that the equilibrium level of transfers is increased by a higher reform value, decreased by a higher benefit from reform and increased by a low residual probability of reforms taking place. This effect mirrors the result from the equilibrium policy surprise value. In both cases the effect of  $f$  will depend on  $f$  being a multiple or a fraction.

We can now determine the equilibrium levels of welfare.

The welfare function of the EU is given by:

$$W_{EU} = \lambda\sigma\beta fM - \lambda M$$

Substituting  $\sigma = 1/\beta f$

$$W_{EU} = \lambda M - \lambda M = 0$$

The equilibrium outcome will thus always result in a zero welfare for the EU. This is a startling result. It suggests that the EU is indifferent between starting the accession process and not entering it in the first place, indicating that the applicant can extract maximum benefit.

Combined welfare ( $W$ ) will thus be the welfare function of the applicant.

The welfare function of the CEEC is given by:



$$WEE = W = R + \lambda\sigma\beta M + (\lambda\sigma^2\beta)R + \lambda M - \sigma R$$

Substituting  $\lambda = fR/(2R + f\beta M)$  and  $\sigma = 1/\beta f$

$$\begin{aligned} WEE = R + fR\beta M / \beta f(2R + f\beta M) + (f\beta R^2 / \beta^2 f^2 (2R + f\beta M) \\ + fRM / (2R + f\beta M) - R / \beta f \end{aligned}$$

The actual influence of the variables on the size and direction of the choice variables is difficult to determine. We will thus use a numerical simulation which will be explored later.

Finally, we can derive the aggregate possibility that reforms will take place.

$$\chi = \lambda\sigma\beta$$

Substituting  $\lambda = fR/(2R + f\beta M)$  and  $\sigma = 1/\beta f$

$$\chi = \lambda/f = R/(2R + f\beta M)$$

Again, we will use a numerical simulation to show the effect of changes in the variables, in determining aggregate uncertainty.

For this section, numerical examples have been constructed. The actual spreadsheet with the different calculations can be found in Appendix A. The numbers do not represent actual estimates, they have merely been chosen to examine the trends in the solutions for the choice variables.

The boundaries which are set up within the model, namely  $\lambda \geq 0$  and  $\sigma \geq 0$ , will not always be met by the crude figures. By excluding those results which exceed these boundaries, as well as only using results yielding  $1 \geq \chi \geq 0$ , we can make a meaningful analysis of the figures. As stated before, the EU

would choose not to get involved in the process if EU welfare is negative<sup>90</sup>. Thus, negative welfare results of the EU can be ignored. The results, which conform to these conditions, will be the ones used in the analysis to maintain consistency with the model.

We will firstly examine  $\beta$ . The residual uncertainty  $\beta$  influences  $\chi$  negatively, i.e. the larger the residual uncertainty, the lower is total uncertainty about reform outcomes.  $\beta$  has an inverse effect on the surprise variable and on the transfer variable. The larger is  $\beta$ , the lower is  $\sigma$ . This means that the policy surprise value increases as the residual probability of reforms happening increases. Transfers decrease as the residual probability of reforms happening increases. Thus the more probable a reform's success is, the lower transfers will be. The policy surprise value for the applicant is high and the resulting aggregate probability of reforms happening is low. This will reduce aggregate welfare.

When examining  $f$ , the results are similar.  $f$  has an inverse effect on the surprise variable and on the transfer variable. The larger is  $f$ , the lower is  $\sigma$ . This means that the policy surprise value increases as the benefit differential between the applicant and the EU increases. Generally  $f$  is estimated to be relatively large, as indicated by many papers (see for example Baldwin, Francois and Portes, 1997). Transfers decrease as  $f$  increases. Thus the higher the differential of membership benefits, the lower transfers will be. The policy surprise value for the applicant is high and the resulting aggregate probability of reforms happening is low. This will reduce aggregate welfare.

Finally, we will examine the relationship between  $M$  and  $R$ . We can clearly see that to obtain meaningful results,  $M$  must be substantially bigger than  $R$ . The larger this differential becomes, the lower the transfer variable will be and total transfers fall. As a result, there will be a lower aggregate probability that the reforms happen and welfare will decrease.

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<sup>90</sup> It can be assumed that in such a case both the EU and the CEEC would not be involved in the process, as they are both rationally forward looking. The welfare of both associated with this process would thus be 0.

We will now examine the case of costly reforms being necessary for membership. Instead of using  $R$ , we will use  $-R$ . The welfare function of the EU is unchanged and thus the equilibrium reaction function is still given by:

$$\sigma = 1/\beta f$$

The welfare function of the applicant has, however, changed. It is now given by:

$$WEE = -dR + dM + \lambda M + (1-d)(1-\sigma)R$$

The surprise function remains unchanged to enable a direct comparison of the surprise variable. Welfare under uncertainty is:

$$\begin{aligned} WEE &= \chi[-R + M + \lambda M] + (1-\chi)[\lambda M + (1-\sigma)R] \\ WEE &= -\chi R + \chi M + \chi \lambda M - \chi \lambda M - \chi(1-\sigma)R + \lambda M + (1-\sigma)R \\ WEE &= -\chi R + \chi M - \chi R + \chi \sigma R + \lambda M + R - \sigma R \\ WEE &= R + \chi M + \chi \sigma R + \lambda M - \sigma R - 2\chi R \end{aligned}$$

Substituting  $\chi = \lambda \sigma \beta$

$$\begin{aligned} WEE &= R + (\lambda \sigma \beta)M + (\lambda \sigma \beta)\sigma R + \lambda M - \sigma R - 2\lambda \sigma \beta R \\ WEE &= R + \lambda \sigma \beta M + (\lambda \sigma^2 \beta)R + \lambda M - \sigma R - 2\lambda \sigma \beta R \end{aligned}$$

To determine the reaction function of the applicant country, we differentiate by  $\sigma$ .

$$\begin{aligned} dWEE/d\sigma &= \lambda \beta M + 2\lambda \sigma \beta R - R - 2\lambda \beta R = 0 \\ \sigma (2\lambda \beta R) &= -\lambda \beta M + R + 2\lambda \beta R \\ \sigma &= -M/(2R) + 1/2\lambda \beta + 1 \end{aligned}$$

Substituting  $\sigma = 1/\beta f$

$$1/\beta f = -M/(2R) + 1/2\lambda\beta + 1$$

$$2/\beta f = -M/R + 1/\lambda\beta + 2$$

$$2\lambda/f + \lambda\beta M/R + 2\lambda\beta = 1$$

$$\lambda (2 + f\beta M/R + 2f\beta) = f$$

$$\lambda = fR/(2R + f\beta M + 2f\beta)$$

We can see that the new term  $2f\beta$  will reduce the amount of transfers as long as this term is positive. As previously demonstrated, this will lower the aggregate probability of reforms taking place and will reduce welfare. The only substantial difference in the effect of the variables on the aggregate possibility is that the probability of reforms happening is lowered by the introduction of more costly reforms.

The previous sections have assumed that the EU has no control over the use of funds. They are bound to pay the transfer whether reforms are introduced or not. This is clearly unrealistic in this extreme form. An examination of the other extreme is required, by exploring the effect of making transfers conditional on reform. The previously introduced model and the dummy factor  $d$  will be used to make the transfers conditional upon the introduction of reforms.

This section firstly considers the decision of the applicant country. The welfare function is given by:

$$\begin{aligned}
WEE &= dR + dM + d\lambda M + (1-d)(1-\sigma)R \\
WEE &= \chi[R + M + \lambda M] + (1-\chi)[(1-\sigma)R] \\
WEE &= \chi R + \chi M + \chi \lambda M - \chi(1-\sigma)R + (1-\sigma)R \\
WEE &= \chi M + \chi \sigma R + R - \sigma R + \chi \lambda M
\end{aligned}$$

Substituting  $\chi = \lambda\sigma\beta$

$$WEE = R + (\lambda\sigma\beta)M + (\lambda\sigma\beta)\sigma R + (\lambda\sigma\beta)\lambda M - \sigma R$$

To determine the reaction function of the applicant country we differentiate by  $\sigma$ .

$$\begin{aligned}
dWEE/d\sigma &= \lambda\beta M + 2\lambda\sigma\beta R - R + (\lambda\beta)\lambda M = 0 \\
\sigma (2\lambda\beta R) &= -\lambda\beta M + R - (\lambda\beta)\lambda M \\
\sigma &= -M/(2R) + 1/2\lambda\beta - \lambda M/2R
\end{aligned}$$

The process is repeated for the EU. The welfare function is given by:

$$WEU = \chi fM - \chi \lambda M$$

Substituting  $\chi = \lambda\sigma\beta$

$$WEU = \lambda\sigma\beta fM - \lambda\sigma\beta\lambda M$$

To determine the reaction function of the EU we differentiate by  $\lambda$ .

$$\begin{aligned}
dWEE/d\lambda &= \sigma\beta fM - 2\sigma\beta\lambda M = 0 \\
f - 2\lambda &= 0 \\
\lambda &= f/2
\end{aligned}$$

The equilibrium level of policy changes can now be derived:

$$\sigma = -M/(2R) + 1/2\lambda\beta - \lambda M/2R$$

Substituting  $\lambda = f/2$  yields:

$$\begin{aligned}\sigma &= -M/(2R) + 1/2\lambda\beta - \lambda M/2R \\ \sigma &= -M/(2R) + 1/f\beta - fM/4R\end{aligned}$$

Again this is analysed by using a numerical simulation. The actual spreadsheet with the different calculations can be found in Appendix B. The numbers do not represent actual estimates, they have merely been chosen to examine the trends in the solutions for the choice variables.

The boundaries which are set up within the model, namely  $\lambda \geq 0$  and  $\sigma \geq 0$ , will not always be met by the crude figures. By excluding those results which exceed these boundaries, as well as only using results yielding  $1 \geq \chi \geq 0$ , we can make a meaningful analysis of the figures. As stated before, the EU would not get involved in the process if EU welfare is negative<sup>91</sup>. As such, negative welfare results of the EU can be ignored. The results, which conform to these conditions, will be the ones used in the analysis to maintain consistency with the model.

The results clearly contradict some of the conclusions from the previous section. When the level of transfers stays constant and the surprise value increases, we get a higher probability that reforms happen and thus a higher welfare, which is similar to the previous section. However, when the level of transfer increases, we get a lower surprise value, which indicates a higher policy surprise. As a result, aggregate uncertainty increases but welfare increases. A high level of remaining uncertainty, expressed by a low  $\beta$ , will have an ambiguous effect. A low value of membership and a high benefit from reforms, together with a decrease in residual uncertainty, will

result in cycling levels of aggregate uncertainty and welfare. Here,  $f$  being a fraction rather than a multiple, will be crucial to determine any results. As  $f$  increases together with a high membership value and a low reform value, the aggregate uncertainty is increased. This does, however, increase welfare. Furthermore, the EU can actually gain welfare from this process and is not indifferent to accession, as in the case of unconditional reforms, even with rational foresight. These are crucial differences to the previous section. It suggests that given a low differential of benefits for the EU and for the applicant, there are circumstances under which there should be conditional transfers to maximise welfare. This suggests that there are two different groups of countries, which should be treated differently.

The analysis has shown that Uncertainty plays a crucial role in the accession process. By endogenising the policy surprise value of an unanticipated change, as well as transfer payments and residual uncertainty, the model throws up some startling results.

When regarding the size of membership benefits for the applicant in comparison to the reform benefits, it is clear that the higher this differential, the lower transfers will need to be. The possibility to create a positive effect by using an unanticipated change increases and thus the aggregate uncertainty increases as welfare decreases. A high effect of present reform programmes is thus desirable while a high benefit from membership acts to reduce the likelihood of accession. This result is unchanged whether the reforms themselves are negative or whether the transfers of the EU become conditional on success of the reforms.

As the residual probability of reforms taking place increases, the lower the transfers will be. At the same time, the policy surprise value will increase, as the applicant's government tries to derive maximum benefit from the decrease in residual uncertainty. This will, however, decrease the aggregate probability of reforms happening and thus will reduce welfare.

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<sup>91</sup> It can be assumed that in such a case both the EU and the CEEC would not be involved in the process, as they are both rationally forward looking. The welfare of both associated with this process would thus be 0.



If there is a high differential between the benefits from membership and the benefits for the EU, the gain from unanticipated policy changes will be substantial. Transfers will be lower if they are unconditional and this will increase aggregate uncertainty and reduce welfare. However, by making transfers conditional on the success of the reforms, the EU can increase aggregate welfare.

Thus the model has demonstrated some interesting features of the accession process, which require application to the present situation. These include facts such as aggregate uncertainty, but more crucially, the effect of transfers and unanticipated policy changes on this process. The implications for policy change and will be later examined, in more detail. It is, however, clear that the results are startling in some aspects. Large benefits from membership for the applicant, as well as a high residual probability of reforms happening, will actually decrease the likelihood of accession. If one assumes that larger benefits are derived from a substantially different country due to comparative advantage, we can demonstrate a further startling result. The results indicate that a country with a high degree of structural differences with the EU should receive unconditional transfers, while a low degree of structural differences suggests conditional transfers. The EU can benefit more in terms of welfare from these countries, while unconditional transfers suggest no welfare gain for the EU. This indicates that the accession process of more structurally sound applicants is of interest for the EU, while the EU is indifferent to not entering or entering the accession process with countries receiving unconditional transfers. This conclusion is reinforced by evidence from the accession process. Baldwin states that:

“The EU’s economic interest in enlargement is probably quite minor ... When an economically small region integrates with an economically larger region, both gain but the smaller region gains much more. Moreover, when a low-wage/low-productivity region and a high-wage/high-productivity integrate, most of the large region’s gains come from cheaper imports of labour intense goods such as clothes and shoes” (1995).

Furthermore, Baldwin reinforces the need for transfers to make membership viable:

“As argued above, the economic gains from membership are likely to be large for the CEECs ... The only big economic gains that would require full membership are exactly those that create the most political problems in the EU: participation in the CAP and transfers to poor regions” (ibid.).

This clearly suggests a different treatment of different groups of applicants and it is thus highly relevant to the management of the accession process. The following tables summarise the theoretical results of this section.

**Table 4.g.1: Summary of results for Type A**

	A: characteristics of type A	A: CEEC strategy/ incentives	A: Transfers EU
Political Feasibility	<ul style="list-style-type: none"> <li>- long accession period</li> <li>- reforms have unequal distributive effects</li> <li>- negative complementarities</li> </ul>	<ul style="list-style-type: none"> <li>- GRAD is optimal</li> <li>- internal redistributive transfers necessary</li> </ul>	<ul style="list-style-type: none"> <li>- need for high, unconditional transfers</li> </ul>
Time Inconsistency	<ul style="list-style-type: none"> <li>- all strategies are time inconsistent</li> </ul>	<ul style="list-style-type: none"> <li>- large incentive to introduce unanticipated changes</li> </ul>	<ul style="list-style-type: none"> <li>- GRAD needs high, conditional transfers</li> </ul>
Uncertainty	<ul style="list-style-type: none"> <li>- high residual uncertainty</li> <li>- high EU/CEEC benefit differential</li> </ul>	<ul style="list-style-type: none"> <li>- large incentive to introduce unanticipated changes</li> </ul>	<ul style="list-style-type: none"> <li>- high, unconditional transfers are needed</li> </ul>
Summary	<ul style="list-style-type: none"> <li>- long accession period</li> <li>- high residual uncertainty</li> <li>- high EU/CEEC benefit differential</li> </ul>	<ul style="list-style-type: none"> <li>- GRAD is optimal</li> <li>- large incentive to introduce unanticipated changes</li> </ul>	<ul style="list-style-type: none"> <li>- high conditional and unconditional transfers are needed</li> </ul>

**Table 4.g.2: Summary of results for Type B**

	B: characteristics of type B	B: CEEC strategy/ incentives	B: Transfers EU
Political Feasibility	<ul style="list-style-type: none"> <li>- short accession period</li> <li>- reforms have few distributive effects</li> <li>- positive complementarities</li> </ul>	<ul style="list-style-type: none"> <li>- BBN is optimal</li> <li>- internal redistribution not necessary</li> </ul>	<ul style="list-style-type: none"> <li>- no need for high, unconditional transfers</li> </ul>
Time Inconsistency	<ul style="list-style-type: none"> <li>- all strategies are time inconsistent</li> </ul>	<ul style="list-style-type: none"> <li>- small incentive to introduce unanticipated changes</li> </ul>	<ul style="list-style-type: none"> <li>- BBN needs low, conditional transfers</li> </ul>
Uncertainty	<ul style="list-style-type: none"> <li>- low residual uncertainty</li> <li>- low EU/CEEC benefit differential</li> </ul>	<ul style="list-style-type: none"> <li>- small incentive to introduce unanticipated changes</li> </ul>	<ul style="list-style-type: none"> <li>- low, conditional transfers are needed</li> </ul>
Summary	<ul style="list-style-type: none"> <li>- short accession period</li> <li>- low residual uncertainty</li> <li>- low EU/CEEC benefit differential</li> </ul>	<ul style="list-style-type: none"> <li>- BBN is optimal</li> <li>- small incentive to introduce unanticipated changes</li> </ul>	<ul style="list-style-type: none"> <li>- low, conditional transfers are needed</li> </ul>

**Table 4.g.3: Summary of results for both types**

	Characteristics	CEEC strategy/ Incentives	Transfers EU
Type A	<ul style="list-style-type: none"> <li>- long accession period</li> <li>- high residual uncertainty</li> <li>- high EU/CEEC benefit differential</li> </ul>	<ul style="list-style-type: none"> <li>- GRAD is optimal</li> <li>- large incentive to introduce unanticipated changes</li> </ul>	<ul style="list-style-type: none"> <li>- high conditional and unconditional transfers are needed</li> </ul>
Type B	<ul style="list-style-type: none"> <li>- short accession period</li> <li>- low residual uncertainty</li> <li>- low EU/CEEC benefit differential</li> </ul>	<ul style="list-style-type: none"> <li>- BBN is optimal</li> <li>- small incentive to introduce unanticipated changes</li> </ul>	<ul style="list-style-type: none"> <li>- low, conditional transfers are needed</li> </ul>

In the following section, these theoretical results will be combined with the results of the previous sections of this chapter, to summarise the key features of the accession process from a modelling perspective.

## Chapter 4: The Model

### h) Results of the theoretical analysis

The models have shown that the constraints substantially influence the choices of the CEECs and the EU. The constraints have to be taken into account in the accession process. Political Feasibility will be a major problem if there is an unequal distribution of benefits and losses. In extreme cases, this might make membership unfeasible. A high benefit from membership is important to overcome this problem, especially if the discount factor is high, i.e. a long time period until accession is expected. The strategies available to the CEECs need to be examined carefully to enable accession. The analysis shows that BBL is never an optimal option, but, depending on some variables, both GRAD and BBN can be optimal. GRAD will be optimal if there is a high discount of future benefits and if the reforms have an unequal distributive effect, while BBN will be optimal if discounts are relatively low and if effects of reforms are relatively evenly distributed. Transfers of the EU, as well as internal transfers, can improve the feasibility of reform programmes. The analysis shows that countries further removed from accession are more likely to have problems of Political Feasibility. This will be especially true if the reforms have unequal distributive effects and will be aggravated by a lack of transfers and by negative complementarities. Conversely countries closer to accession are less likely to have problems of Political Feasibility. They will benefit if the reforms have few unequal distributive effects and will require lower transfers, especially if there are positive complementarities.

Time Inconsistency is also a major problem in the accession process. The CEEC government generally has an incentive to go back on earlier announcements about reform strategies, especially when costly reforms are announced. Therefore, the population cannot believe announcements and *ex ante* all reform strategies (BBN, BBL and GRAD) are Time Inconsistent. EU conditional transfers will be necessary to enforce accession strategies, but the

size of these transfers will depend on the accession strategy which is chosen. BBL requires the highest conditional transfer, but GRAD also requires a relatively high conditional transfer. BBN requires a relatively low conditional transfer.

It is clear from the analysis that Uncertainty reduces welfare and that EU transfers and unanticipated changes crucially influence the probability of reforms and membership taking place. A high degree of residual uncertainty can act to encourage large unconditional transfers. If the EU's membership benefits are high in comparison to the applicant's benefits, large unconditional transfers are optimal. A high incentive of introducing unanticipated changes will, however, be present. If EU membership benefits are comparable to the applicant's benefits, conditional low transfers will be optimal. A low incentive to introduce unanticipated changes will be present in that case.

Thus, the analysis has shown that there are two distinctive types of countries. Type A is far away from accession and a gradual strategy is optimal, while type B is close to accession and the immediate introduction of the remaining reforms is optimal. These theoretical results are summarised in the following tables.

**Table 4.h.1: Summary of results for Type A**

	A: characteristics of type A	A: CEEC strategy/ Incentives	A: Transfers EU
Political Feasibility	<ul style="list-style-type: none"><li>- long accession process</li><li>- reforms have unequal distributive effects</li><li>- negative complementarities</li></ul>	<ul style="list-style-type: none"><li>- GRAD is optimal</li><li>- internal redistributive transfers necessary</li></ul>	<ul style="list-style-type: none"><li>- need for high, unconditional transfers</li></ul>
Time Inconsistency	<ul style="list-style-type: none"><li>- all strategies are time inconsistent</li></ul>	<ul style="list-style-type: none"><li>- large incentive to introduce unanticipated changes</li></ul>	<ul style="list-style-type: none"><li>- GRAD needs high, conditional transfers</li></ul>
Uncertainty	<ul style="list-style-type: none"><li>- high residual uncertainty</li><li>- high EU/CEEC benefit differential</li></ul>	<ul style="list-style-type: none"><li>- large incentive to introduce unanticipated changes</li></ul>	<ul style="list-style-type: none"><li>- high, unconditional transfers are needed</li></ul>
Summary	<ul style="list-style-type: none"><li>- long accession process</li><li>- high residual uncertainty</li><li>- high EU/CEEC benefit differential</li></ul>	<ul style="list-style-type: none"><li>- <b>GRAD is optimal</b></li><li>- large incentive to introduce unanticipated changes</li></ul>	<ul style="list-style-type: none"><li>- <b>high conditional and unconditional transfers are needed</b></li></ul>



**Table 4.h.2: Summary of results for Type B**

	B: characteristics of type B	B: CEEC strategy/ Incentives	B: Transfers EU
Political Feasibility	- short accession process - reforms have few distributive effects - positive complementarities	- BBN is optimal - internal redistribution not necessary	- no need for high, unconditional transfers
Time Inconsistency	- all strategies are time inconsistent	- small incentive to introduce unanticipated changes	- BBN needs low, conditional transfers
Uncertainty	- low residual uncertainty - low EU/CEEC benefit differential	- small incentive to introduce unanticipated changes	- low, conditional transfers are needed
Summary	- short accession process - low residual uncertainty - low EU/CEEC benefit differential	- BBN is optimal - small incentive to introduce unanticipated changes	- low, conditional transfers are needed

The analysis has shown that there are two distinct types of countries. The distinction between the two types depends crucially upon the benefit from membership ratio of the EU and the CEEC. Discounting can be interpreted as a proxy for the total size of membership benefits. The distance from accession will also be crucially important. Residual uncertainty and aggregate uncertainty increase the need for large transfers, as well as an uneven distributional effect of reforms. The applicant’s strategy and incentive to introduce unanticipated changes will be different for both types. In the case of countries close to accession, the introduction of reforms should happen as fast as possible, while countries further away from accession should introduce reforms gradually. The EU should also use a different transfer strategy, as well as differently sized transfers, for both types. The countries close to accession should receive low, conditional transfers, while countries distant

from accession should receive large, unconditional transfers. These results are summarised in table 4.g.3.

**Table 4.h.3: Summary of results for both types**

	Characteristics	CEEC strategy/ Incentives	Transfers EU
Type A	<ul style="list-style-type: none"> <li>- long accession process</li> <li>- high residual uncertainty</li> <li>- high EU/CEEC benefit differential</li> </ul>	<ul style="list-style-type: none"> <li>- GRAD is optimal</li> <li>- large incentive to introduce unanticipated changes</li> </ul>	<ul style="list-style-type: none"> <li>- high conditional and unconditional transfers are needed</li> </ul>
Type B	<ul style="list-style-type: none"> <li>- short accession process</li> <li>- low residual uncertainty</li> <li>- low EU/CEEC benefit differential</li> </ul>	<ul style="list-style-type: none"> <li>- BBN is optimal</li> <li>- small incentive to introduce unanticipated changes</li> </ul>	<ul style="list-style-type: none"> <li>- low, conditional transfers are needed</li> </ul>

The analysis of the theoretical model demonstrates a need to distinguish between different types of accession candidates. The conclusions cannot be applied directly to the applicant countries in so far as the models are simplified to capture the process. Nevertheless, the distinction between countries close to accession and countries further away should be taken into account. The size and nature of transfers associated with each type should be applied, instead of using the same method for all CEE applicant countries.

Preliminary analysis seems to support the conclusions of the theoretical models. Two different groups, and possibly intermediary groups, of countries can be identified. The Commission has separated the applicants into two groups by designating them First and Second wave. This, in part, might be a self-fulfilling distinction as the designation into Second wave means people expect a longer accession period. A more rigorous timetable of accession might enable the decision to treat countries differently, over time. A longer accession period could mean the gradual introduction of reforms as well as large conditional and unconditional transfers.

The examination of the recent history of the applicants should yield evidence of Political Feasibility, Time Inconsistency and Uncertainty problems. It is clear that the analysis highlights some important aspects of the accession process. Thus, there is a need to examine the problems of Political Feasibility, Time Inconsistency and Uncertainty in more detail. Indeed, there are indications that these economic problems are occurring and that the CEECs fall into different categories. A change in the strategy of the CEECs and the EU thus seems to be necessary, especially for those countries which appear to be lagging behind in the accession process. The evidence of constraints is examined in the next chapter.

## **Chapter 5: Evidence of Economic Constraints**

### **a) Evidence of constraints in the applicant countries**

Initially, the EU opened accession talks with five of the applicants, but decided at the Helsinki Summit in December 1999, to expand the accession talks to the remaining five applicant countries<sup>92</sup>. Of these five countries, Bulgaria and Romania are, at present, the furthest behind the EU, in economic terms, as demonstrated in Chapter 3 of this thesis. Despite the inclusion of these countries, serious doubts have been raised as to whether Bulgaria and Romania will become full members of the European Union in the foreseeable future. Yet they remain optimistic about membership. In April 2000, Petre Roman, the Romanian Foreign Minister, stated that:

“It is our aim to make up lost ground in the negotiations, and we have basically succeeded in doing that” (Frankfurter Allgemeine Zeitung, 6.4.2000).

This chapter analyses the evidence of constraints in the accession process from the view of the applicants. The accession process is a one-sided affair, almost determined entirely by the Commission on behalf of the EU. The EU has published two Progress Reports and in both, Romania and Bulgaria remain at the end of the list of accession countries, albeit they have changed their respective positions to each other. It seems that, despite making some efforts to fulfil the accession criteria, these countries are still far away from eventual membership.

All the CEECs face major difficulties in the accession process. The model developed in the previous chapter suggests that one of the main constraints is the problem of Political Feasibility. The CEECs need to maintain a political constituency for membership in the accession process. The model indicates that the constraints will be especially prevalent for governments in

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<sup>92</sup> Cyprus and Malta join the ten CEECs and Turkey has become a membership candidate but will not be included in negotiations immediately.

those applicant countries, which face a long accession process and a costly readjustment.

Residual uncertainty is a further problem in the accession process. The accession process entails a high degree of Uncertainty surrounding outcomes. Furthermore the model has demonstrated that the choices of the CEEC governments and the EU crucially influence the probability of reform, and consequently accession, taking place. These choices, combined with aggregate Uncertainty, make decisions about timing and sequencing of reforms extremely risky and, as the reforms are necessary conditions for membership, Uncertainty can endanger membership itself.

The model suggests that Time Inconsistency is a key determinant of the accession process, especially in light of the EU's transfer strategy, as detailed in the pre-accession strategy of Agenda 2000. Time Inconsistency demonstrates a serious commitment problem, which could lead to delays in the accession process. The CEECs need to commit to a strategy to manage the accession process without reneging on promises of reform. The model has shown that governments can benefit from surprising the population and markets, which creates an incentive to renege on pre-announced strategies. This could jeopardise the accession process, especially when the lack of a firm commitment mechanism alters expectations by the economic agents.

There are already signs of these constraints. Political Feasibility problems are noted most frequently:

"In most of the ten CEECs, positive views of the EU were high in the early years of transition and then declined" (Grabbe and Hughes in Henderson, 1999, p. 186).

Time Inconsistent behaviour can also be observed. Commenting on the case of Slovakia, Karen Henderson states that:

"The new government's programme stated that "the government considers the implementation of the programme of European integration its foremost

task", but its real commitment to this goal was questionable" (in Henderson, 1999, p. 227).

Uncertainty is closely linked to this problem. It is endemic in any transformation and can be observed frequently in the accession process. As Jackie Gower states in the context of the problems of the accession negotiations:

"There remain, therefore, many outstanding issues and uncertainties about the CEEC's accession to the EU" (in Henderson, 1999, p. 16).

The model suggests that these constraints are especially prevalent in countries far from accession, such as Romania and Bulgaria. These countries already started the accession process behind the other accession countries, in economic terms. Romania was ruined economically by the dictatorship of Ceaucescu, while Bulgaria adopted the Soviet model most faithfully by introducing a rigid, and inefficient, planned economy. As a consequence of this lower starting point, and the failure to initiate decisive reform in the post-revolution years, these countries continue to lag behind. GDP per capita in Bulgaria stands at 23% of EU average, while Romania is slightly ahead at 27%. In both countries, there is still a strong agricultural sector and industrial production is still below the 1995 average. Inflation is over 20% in Bulgaria and almost 60% in Romania. Trade is less than 1% of extra-EU trade, despite these countries being among the more populous applicants with a population of 22.5 million in Romania and 8.2 million in Bulgaria<sup>93</sup>. The democratisation process has advanced, but Bulgaria and Romania still face many problems, which will be later examined. Thus, their economic situation is still substantially below the EU average and, indeed, at the bottom end of the applicant countries, while the political process seems to be stagnating. The link between these developments and the accession process has not been examined in previous literature in great detail and the model and the

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93 Data taken from Eurostat, Memo No 10/99- 7 December 1999.

following discussion attempt to address this gap.

The accession process is characterised by choices and is by no means an automatic process with a defined endpoint. The EU must choose how to use transfers in the best way to encourage the necessary reforms to enable accession, while the CEEC governments must choose the best strategy for the implementation of these reforms. The optimal method of preparing for accession is, however, difficult to define. The model developed in the previous chapter has indicated that constraints are crucially important to examine in the accession process. The following section examines the accession literature to determine whether these constraints are observable in the accession countries.

The EU crucially influences the accession process. Not only does the EU set the conditions for membership but it also influences other choice variables in the process. The model has demonstrated the importance of the size of transfers and whether transfers are dependent upon introducing reforms by the CEECs. Even though the applicant can choose to utilise internal redistribution to correct effects caused by the accession process, this is limited by the lack of public funds. The EU can choose unconditional transfers the applicant receives without a punishment if reforms are not introduced. Conditional transfers are tied to the success of the reform process and will be cancelled if the process falters.

The variables, which are determined by the CEECs, are related to the introduction of reforms and whether there is a credible pre-commitment to this process. The applicant's strategy is mainly linked to the speed of introducing reforms. Under Big Bang Now (BBN), the applicant chooses to introduce all reforms as soon as logistically possible. This would involve introducing beneficial as well as costly reforms immediately. Big Bang Later (BBL), on the other hand, involves the introduction of all reforms as late as logistically possible, i.e. immediately prior to accession. Under Gradualism (GRAD) the applicant chooses to introduce some reforms immediately and some prior to accession. This would involve deferring some costly reforms to



the future.

The applicant needs to commit to any one of these strategies to be able to introduce the reforms. This may occur, under certain circumstances, by “tying his hands” to a certain accession process. There is, however the possibility that the applicant reneges on a strategy. The applicant can choose not to introduce a pre-announced reform if this is beneficial for the economy. Under such circumstances, economic agents know about this incentive and will not believe an announced strategy.

The CEEC governments will only initiate reform programmes if they do not decrease their electoral chances. These will be decreased if the voting majority suffers from the programmes. The distributional effect of these programmes will thus have to be taken into account. These will be influenced by internal transfers and by the interaction of reforms. This is the problem of political feasibility. David Phinnemore states that:

“If CEECs are required to assume early on the more economically burdensome elements of the *acquis*, such as environmental, health and safety standards, fears of job losses could dampen enthusiasm for membership” (in Henderson, 1999, p. 78).

Even though the aggregate effect of membership is beneficial, this effect is discounted when considering the present situation. As reforms are positive as well as negative, they will affect different groups in society to varying degrees. Transfers, especially of the EU, can increase the benefits for all groups and thus reduce the problem of Political Feasibility.

The CEEC governments cannot commit credibly to a reform programme, as any announced reform can be cancelled later. This can bring benefits to the economy if people adjusted to a negative reform and then it does not take place. Given this incentive, the people will not believe any government announcements. But as the reforms are necessary for EU membership, the population will forego the discounted benefit from membership. Because the EU can make transfers contingent upon reforms, the

EU can commit the applicant government to a reform programme. It is thus necessary to determine which strategy might be Time Inconsistent and what size of EU transfers is necessary to credibly commit the applicant government to a reform programme.

The choices of the CEEC and the EU are made in an uncertain world and their choices will influence the likelihood of reforms and membership. Both the EU and the CEEC government have to take the choice of the other into account, in order to derive the best option for themselves, but there will be a residual uncertainty neither of them can influence. The final probability of reforms and membership taking place will depend crucially upon whether EU transfers are conditional on reform programmes or unconditional. But the probability of reforms and membership taking place will also depend crucially on the incentive to renege on earlier announcements of the CEEC government.

The models have shown that the constraints substantially influence the choices of the CEECs and the EU. The constraints are thus fundamental in the accession process. Political Feasibility will be a major problem if there is an unequal distribution of benefits and losses. In extreme cases, this might make membership unfeasible. A high benefit from membership is important to overcome this problem, especially if the discount factor is high, i.e. a long time period until accession is expected. The strategies available to the CEECs need to be examined carefully in order to enable accession. The analysis shows that BBL is never a politically feasible option, but, depending on some variables, both GRAD and BBN can be optimal. GRAD will be optimal if there is a high discount of future benefits and if the reforms have an unequal distributive effect, while BBN will be optimal if discounts are relatively low and if effects of reforms are relatively evenly distributed. Transfers of the EU, as well as internal transfers, can improve the feasibility of reform programmes. The analysis shows that countries further removed from accession are more likely to have problems of Political Feasibility. This will be especially true if the reforms have unequal distributive effects and will be

aggravated by lack of transfers and by negative complementarities. Conversely, countries closer to accession are less likely to have problems of Political Feasibility. They will benefit if the reforms have few unequal distributive effects and will require lower transfers, especially if there are positive complementarities.

Time Inconsistency is also a major problem in the accession process. The CEEC government generally has an incentive to renege on earlier announcements about reform strategies, especially when costly reforms are announced. Announcements will, thus, not be believed by the population and, *ex ante*, all reform strategies (BBN, BBL, and GRAD) are time inconsistent. EU conditional transfers will be necessary to enforce accession strategies, but the size of these transfers will depend upon the chosen accession strategy. BBL requires the highest conditional transfer, but GRAD also requires a relatively high conditional transfer. BBN requires a relatively low conditional transfer.

It is clear from the analysis that Uncertainty reduces welfare and that EU transfers and unanticipated changes crucially influence the probability of reforms and membership taking place. A high degree of residual uncertainty can act to encourage large unconditional transfers. If the EU's membership benefits are high in comparison to the applicant's benefits, large unconditional transfers are optimal. A high incentive of introducing unanticipated changes will, however, be present. If EU membership benefits are comparable to the applicant's benefits, conditional low transfers will be optimal. Under such circumstances, a low incentive to introduce unanticipated changes will be present in that case.

Thus, countries facing a long accession process are characterised by high residual uncertainty and a high EU/CEEC benefit differential. A gradual strategy is optimal but there is a large incentive to introduce unanticipated changes and, thereafter, problems of political feasibility will be apparent. In general, high conditional and unconditional transfers by the EU are needed to minimise the costs of the process of accession.

In the following sections the countries are examined together and then individually to determine whether evidence of constraints can be found. From the theoretical model we would expect to find most evidence in those countries furthest from membership. Furthermore, we would also expect a strong link between the constraints, as demonstrated by the model.

## **Chapter 5: Evidence of Economic Constraints**

### **b) Winners and Losers?**

#### **i) Evidence for all applicant countries**

"Western Europe was stirred by the peaceful changes of regime and the prospect of democracy in the East. But the difficulties of the transformation have caused some disillusion in both East and West. People need a clearer idea of the future of democracy if they are to have the confidence to overcome the difficulties and do what is needed to see the changes through" (Pinder in Pridham, Herring and Sanford, 1994, p. 140).

Initially, public support for enlargement in all CEECs was very strong. However, if public support declines it becomes much more difficult to maintain a political constituency for the process. There are already signs of Political Feasibility problems in the accession process as a whole and one can also see an endemic level of Uncertainty and Time Inconsistency. In consequence of these economic constraints, it can be noticed that expectations for rapid accession are losing momentum. The European Communities Committee of the House of Lords comments that:

"Although we recognise the need to keep up momentum, we think that the target dates being quoted both by the applicants and by the Commission may well be over-optimistic. We consider that it might be better for that to be explicitly recognised now" (House of Lords, 21st Report, 1999, p. 27).

The report recognises

"the danger of arousing expectations which will not be satisfied if momentum is lost" (ibid. p. 33),

implicitly acknowledging the problem of Political Feasibility. These problems exist in the accession process as a whole. In addition, a higher incidence of Political Infeasibility, Time Inconsistency and Uncertainty problems in those countries furthest removed from accession is to be expected. This is a problem, which is generally perceived in the accession process, as the process seems to be too slow for even the most advanced countries. This has led to an

examination of the accession process as a whole. Even the House of Lords noted that the members

“were concerned that the process might be slowing down” (House of Lords, 1999, p. 6).

Among the reasons for the slowing down of the process is the patchy nature of reforms so far achieved:

“Not all of them are all the way there, or even half of it. The rule of law is not universal; corruption is still widespread; clapped-out industries are unready for stiff competition; air is polluted and rivers are foul: the list goes on” (The Economist, 7.11.1998).

The inclusion of the Second Wave countries in the negotiation process has raised hopes in these countries:

“The hopes of most of the countries excluded from the First Wave at the Vienna summit in December 1998 that they can catch up with their rivals look optimistic, to say the least” (European Voice, 2000, p. 64).

These hopes are likely to be unfulfilled. One of the problems outside the control of the CEECs is the lack of progress in EU institutional reform, which could have an adverse effect on the confidence of applicants. There is a

“...fear that the most likely outcome is that the pace of enlargement will be constrained by failure to agree on the detail of institutional reform. This would be seriously damaging to the confidence of the applicants” (House of Lords, 1999, p. 9).

“Not that enlargement was ever likely to be a simple affair: it means changing the balance of power among existing members, reforming the way the EU is run and directing subsidies away from some of the poorer regions in Europe’s West to even poorer newcomers from the East” (The Economist, 21.3.1998).

The scale of reforms necessary should not be underestimated:

"Eastern enlargement seems to be the most challenging enlargement in the whole history of European Integration. Unlike previous enlargements, it will entail numerous structural changes to EU institutions and procedures" (Bárta, 1998, p.1).

The institutional problems of the EU have been demonstrated on numerous occasions. The reform of the CAP is one of the issues, which consistently reappears in the accession process. This problem is particularly important for Poland:

"With such feeble reform of farm policy, it seems increasingly doubtful whether the EU can rapidly absorb a Poland of 39m people, including more than 2m farmers" (The Economist, 10.4.1999).

"Changes to the structural funds could be even more controversial still, not least because they require unanimous approval, whereas CAP changes don't" (The Economist, 21.3.1998).

The problem remains that, without extending the EU's budget, current policies cannot be extended to the applicant states. The applicants have noted this:

"They are already warning that the EU has simply not budgeted for the costs of extending the payments to new member states, judging by the financial provisions laid down in the deal for 2000-2006 struck by Union leaders in March 1999" (European Voice, 1999, p. 63).

"But the pressure is on the applicants. As the jostling in the doorway of the rich men's club continues, the length of the process and its sheer complexity is itself causing problems" (The Guardian, 29.6.1999).

But the CEECs must introduce reforms to prepare themselves at the same time. Costly reforms can create political feasibility problems in the accession process. It is now generally agreed that there will have to be transition periods for some areas of the *acquis*:

"It is clear that the obligation to match EU environmental standards will impose enormous demands in both financial and human resources which



none of the applicant States will be in a position to meet for some years” (House of Lords, 1999, p. 9).

But even in the field of environmental reform the EU is not going to accept indefinite transition:

“The European Commission may tolerate a short transition period. But the EU will not tolerate slackers” (The Economist, 11.12.1999).

In a theoretical paper by Jan Fidrmuc, the problems of political support for reforms are further explored. The paper demonstrates that excessive unemployment can cause problems of political feasibility:

“These results show that the continuation of economic reform can indeed be put at question if unemployment gets too high” (1996, p. 16).

The distributional impact of reforms can change the political constituencies during the reform process, further creating political instability:

“... if radical reform is endorsed by state-sector workers at the outset, the same workers will eventually want to slow it down. The ‘backlash’ develops even when these workers are becoming better off over time” (Rodrik, 1995, p. 22).

The EU has announced that the applicants would be monitored more strictly to determine whether promises are kept. But this is unlikely given the problem of Time Inconsistency:

“This is designed to keep up the pressure on the hopefuls to maintain the pace of reform at home, but it threatens to prolong the haggling if candidates are unable to match their words with deeds” (European Voice, 2000, p. 63-64).

Despite the optimistic mood at the beginning of the accession process, problems were noted from an early stage. Andrzej Olechowski, the then Polish foreign minister, stated that:

"The road to the Union will be long, hard and uncertain" (as quoted in Transition, 30.1.1995, p. 750).

The House of Lords noted that uncertainty makes an agreed timetable for accession impossible:

"We do not think that there is any realistic prospect of setting a formally agreed timetable either for the closure of individual chapters or for the overall completion of negotiations. This does not mean that the targeting should be abandoned, but it should be seen as aspirational, because there are too many uncertainties for the EU to commit itself to targets being met" (House of Lords, 1999, p. 8).

The EU has made it clear that no date will be set for accession. The member of the Commission responsible for enlargement, Verheugen, has consistently reinforced this message, as, for example, in a speech in Warsaw in connection with the reforms to be decided at the IGC:

"The prospect of seeking solutions to these difficult issues may of course seem daunting, and there is sometimes talk of fears that negotiations may be "delayed". This is a false dilemma. There is no imperative cut-off date, at which enlargement must take place, come what may and at any cost. There can be no such date because a badly prepared enlargement will weaken the Union, instead of enriching it. It will also be a missed opportunity for the candidate countries to complete the momentous transformation of their societies, which needs to be done, with or without accession to the EU" (11.5.2000).

This lack of commitment has, however, been criticised by the applicant countries, who find it more and more difficult to maintain a political constituency for the necessary reforms:

"Eastern officials say they need the incentive of a clear date for EU entry to win over workers, bureaucrats and businessmen for the difficult reforms needed to leave behind the stagnation and poverty inherited from communism" (International Herald Tribune, 19.6.2000).

Problems of Uncertainty created by the EU in the accession process have also been noted:

"Several applicant countries have criticised the EU for sending out confusing signals about its intentions. The sorest point has been the persistent refusal of European leaders to set even a provisional target date for admitting the first new members. Candidates complain that they cannot carry on indefinitely with the contentious and costly reforms needed to qualify for membership without some firm date to concentrate minds and stiffen backbones at home" (The Economist, 23.10.1999).

Recent developments have further added to the uncertainty inherent in the accession process:

"The first three or four new members are generally expected to join in 2004, give or take a year - or they were until recently, at any rate. The entry of the far-right Freedom Party into the Austrian government has injected a new note of uncertainty, since each admission requires the unanimous agreement of existing members" (The Economist, 12.2.2000).

The House of Lords notes that the funds allocated to accession in Agenda 2000 might be too low:

"... we are less convinced that the new financial perspectives will provide sufficient resources for, and we urge that it should be reviewed ..." (House of Lords, 1999, p. 8).

Thus, there is evidence of all of the constraints in the accession process as a whole. From the theoretical model introduced in Chapter 4, we would expect that those countries furthest away from accession would face the most severe constraints. From the historical development presented in Chapter 2, and the current situation examined in Chapter 3, we would expect that Bulgaria and Romania, and to a lesser extent, Latvia, Lithuania and Slovakia, would be in this category. The following section examines all the applicant countries in turn, to determine whether the constraints highlighted by the model are most prevalent in those countries furthest from accession, as predicted in the previous section.

## **Chapter 5: Evidence of Economic Constraints**

### **b) Winners and Losers?**

#### **ii) The Baltic States**

The Baltic States have faced particular problems since their transition. In particular, they were required to create a market economy, and they also had to establish completely new institutions after being an integral part of the Soviet Union, as well as managing this volatile relationship. In economic terms, the Baltic States had to create an independent economy from scratch with a collapse of trade and the threat of energy shortages aggravating the situation:

“In some ways, indeed, their current economic difficulties are more severe, given the enormous complexity of changing from a centrally planned economy to a market one” (Smith, 1994, p. 179).

Ethnic divisions within the Baltic States, most notably a significant Russian minority, further complicate the transition:

“In 1991, the Baltic States also inherited an ethnic legacy of decolonisation, the presence of large Russian-speaking communities, but which, at least in the case of Estonia and Latvia, citizenship legislation has not fully resolved” (ibid. p. 8).

The ethnic situation is still not fully resolved:

“Today, the population of Estonia is 30 percent Russian; of Latvia, 34 percent; of Lithuania, much lower at 9 percent ... The potential for social instability is therefore considerable” (Yergin & Gustafson, 1994, p. 249).

Despite Estonia becoming a First Wave country, the Baltic States are examined together in this section. This is partially done in view of the strong historical similarity and their experience during the revolutions and, in part, because of the lack of accession literature on individual Baltic States.

Estonia has been one of the front runners of accession. Yet even for a country like Estonia, expectations after the revolutions were unfulfilled. An early publication on Estonia states:

“Despite all the problems, chances were good that Estonia would privatise, improve quality, and reinvest at a rate sufficient to start catching up with the other Nordic countries. Within a few years, it was likely to become an associate member of the European Community, with full membership possible by the year 2000” (Taagepera, 1993, p. 216).

It is clear that the few years to EU membership have stretched further than expected initially.

Latvia has lagged behind Estonia, especially in the field of economic reforms. The transition process was not carried out as decisively as in Estonia and, consequently, privatisation has lagged behind, as examined in Chapter 3. Latvia was thus designated a Second Wave country in Agenda 2000. The 1999 Progress Report has, however, recognised the progress made and it is likely, that Latvia will be included in the First Wave in the near future.

The Commission also classified Lithuania as a Second Wave country. EU membership has been an explicit goal of Lithuania’s consecutive governments since the break away from the Soviet Union, yet the population does not necessarily share this enthusiasm:

“Although the government is flush with pleasure at the EU’s invitation in Helsinki, many ordinary Lithuanians are not so keen” (The Economist, 8.1.2000).

Lithuania appears reluctant to accept the closure of the Ignalina nuclear power station, albeit that this is a clear condition for EU membership:

“Given that the Lithuanian government intends to decommission the plant at some point, the solution is likely to be that decommissioning is delayed for a further five years or decade, with Lithuania remaining in the ‘second round’ group of applicants for EU membership as a consequence” (Field, 1999, p. 11).

The closure of the plant is now scheduled for 2005, with membership delayed at least until then.

By the early 21<sup>st</sup> Century the Baltic States have made some progress. Estonia is continuing on the fast track with Latvia and Lithuania starting to close the gap. Latvia has made some progress in the over-due privatisation process, while Lithuania has finally declared the intention to close the nuclear plant at Ignalina by 2005. Yet there is still some doubt about how fast the EU can integrate these countries. In a recent article the *Sueddeutsche Zeitung* reported that there is a distinct danger that the current waiting position could become a loop without an endpoint in sight (*Sueddeutsche Zeitung* online, 5.6.2000).

We can, thus, observe evidence of constraints in all the Baltic States. It is, however, clear that Estonia has been the most successful Baltic applicant, where constraints are least prevalent. Latvia has advanced since the first progress report, yet economic constraints still hinder acceptance into the First Wave. For Lithuania, the constraints are most noticeable especially with regard to the closure of the Ignalina nuclear power plant, which is still surrounded by uncertainty.

## **Chapter 5: Evidence of Economic Constraints**

### **b) Winners and Losers?**

#### **iii) Bulgaria**

Bulgaria is still struggling to catch up with the First Wave of accession candidates:

“Bulgaria, ... , gets a big pat on the shoulder for trying hard - but there is still no question of membership in the near future” (Business Central Europe, December 1998/January 1999, p. 46).

Bulgaria has now been included in accession negotiations with the other Second Wave applicants (not least because of the support for NATO in the Balkan conflict). As a result, a more optimistic mood can be noted. Yet, cautious voices have already been raised:

“But once the euphoria generated by the decision to give them a seat at the negotiation table subsides, the six will soon realise this is only the start of a long journey leading to eventual membership of the Union” (European Voice, 2000, p. 64).

In Bulgaria the situation has been different to most accession countries since the changes which took place in 1989 and the early 1990s. Immediately after the overthrow of Zhivkov, very few economic reforms were introduced. Reforms only started in 1991 partially due to reform demands by the IMF. These did not produce the desired results. A noticeable feature of that time was political instability, with allegations of widespread corruption. Inflation spiralled out of control and in late 1991 the opposition, United of Democratic Front (UDF), won the general election. This new government was not able to introduce decisive reforms, despite pledging themselves to move the reform process forward in the run-up to the elections. This demonstration of Time Inconsistent policies resulted in a further deterioration of the economic situation. In 1995, the former communists were reinstated into government and the reform process almost ceased to progress. In mid-1996 the economy



had all but collapsed and only the electoral victory of the UDF in 1997 stopped the deterioration. The link between EU transfers and the reform process can be illustrated by the proposed shutdown of the nuclear power station, Kosloduj. The Bulgarian government had previously agreed to shutdown the four oldest reactors by the end of 1998. This was revoked by the parliament until such a time when Bulgaria and the EU would come to an agreement concerning the associated costs, clearly demonstrating the problems of Time Inconsistency in the absence of large transfers.

Further evidence of economic constraints in countries far removed from accession comes from a paper by David Phinnemore (1999). His arguments apply to the Balkan applicants, Bulgaria and Romania, and should be read to refer to both. He draws attention to the significant costs associated with the accession process for those countries furthest removed from membership. He asserts that financial assistance is being made available by the EU but that these states might be unwilling to spend further funds if guaranteed membership is not the perceived outcome of the process. He draws attention to the possibility that harmonisation might lead to the undermining of the ability of these countries to achieve the economic reforms, which are necessary to fulfil the Copenhagen economic criteria. The evidence thus points to the inappropriateness of the conditionality imposed on the countries furthest away from accession. Furthermore, there is an indication that the funds of the EU are insubstantial to give these countries a sufficient incentive to continue the accession process. He also mentions a problem of Political Feasibility:

“Within the domestic political arena, governing parties may find themselves unable to justify the use of resources for legislative approximation and harmonisation” (Phinnemore, 1999, p. 15).

He warns that:

"If the EU is intent on promoting integration with its European associates and ensuring domestic support within those states for closer ties, a situation whereby states and their populations sense imposition without reward needs to be avoided." (ibid. p. 17).

This further indicates the possibility of running into problems of political feasibility.

The economic problems of the Balkan applicants persist:

"Bulgaria and Romania, having been so disastrously served by previous governments, are at the bottom of the list on economic criteria. They say they are determined to pursue reform and attract investment. If they do, and are rewarded with fast growth, their time in the EU's waiting room could shorten considerably. If they don't, then they will at some point just drop off the list" (Business Central Europe, July/ August 1997).

Bulgaria is among the poorest European countries. Within the accession process, Bulgaria lags far behind the First Wave of applicants. Evidence of constraints is noticeable throughout the last decade. Time Inconsistent policies, in part, caused by changes in government have deterred FDI and reform progress. Governments have been unstable, leading to a high degree of Uncertainty, in political and economic life. Consequently, Bulgaria's prospects, despite some positive developments in the late 1990s, are still bleak. It is unlikely that Bulgaria will become a member of the European Union in the foreseeable future. Indeed, there have to be doubts about Bulgaria achieving membership at all.

## Chapter 5: Evidence of Economic Constraints

### b) Winners and Losers?

#### iv) Czech Republic

"The positive aspects of the accession of the CEEC will not show immediately for the biggest part of the population. ... On the background of growing foreign direct investment a possible result could be a rising apprehension over a "selling-out" of the country and subsequently an increase in nationalism as has been noted, e.g. in Poland and the Czech Republic. As a consequence, the effort for reforms might slow down and the political support of adopting EU regulations could decline" (Jacobsen, 1997, p. 7).

The Czech Republic, once considered as the front runner for accession, now lags behind the other First Wave countries. One of the reasons is that the political leadership has not always been supportive of the Commission's role in the process:

"Whereas most Czech politicians seem ready to do almost anything to get their country into the European Union as fast as possible, Mr. Klaus does not conceal his dislike of Brussels (The Economist, 23.1.1999).

The most notable economic constraints have been evident in the Czech Republic in the exchange rate crisis, which hit the Czech Republic in 1997. Partially as a consequence of this crisis, the Czech Republic has moved from being the front-runner of the accession process to the bottom of the list of the First Wave. The main direct effect of the crisis was that the Czech Crown's peg to the Deutsche Mark had to be abandoned. Initially the peg was directly to the dollar with a narrow band of plus or minus 0.5%. A significant Deutsche Mark component<sup>94</sup> was introduced in 1993. Currency speculation in 1996 led to attempts to stabilise the peg by introducing a wider band of plus or minus 7.5%. Yet renewed speculation in May 1997 was too much and in consequence, the peg was abandoned in favour of a managed float. Even though there were some external factors,

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<sup>94</sup> Pegging the Crown to a basket of 65% Deutsche Mark and 35% US dollars.

“... it is difficult to see the Czech crown as the innocent victim of speculative frenzy. The trend deterioration of competitiveness, sustained over several years, was evident” (Begg, p. 26, 1998).

The Czech Republic has been one of the front-runners of the accession process. Consequently, the Commission designated it as a First Wave country in Agenda 2000. However, since then, the Czech Republic has experienced strong political constraints. Furthermore, the currency crisis of 1997 has shaken confidence in the Czech model of transition. This has led to policies being perceived as Time Inconsistent and the resulting Uncertainty has made speedy accession doubtful. As a result, the Czech Republic, once considered the most likely first new member state, has moved towards the end of the queue of First Wave countries.

## **Chapter 5: Evidence of Economic Constraints**

### **b) Winners and Losers?**

#### **v) Hungary**

Hungary is now regarded as the most likely candidate for early accession. Yet even in Hungary the process is not smooth. Some of the problems became apparent, when the new Fidesz party took power and clashed with the EU on the handling of transfers under the PHARE programmes:

“The EU’s ambassador in Budapest, Michael Lake, recently assailed the government’s handling of EU grants under the PHARE programme of aid to the ex-communist countries. ... Half the money provided in the 1996’s three year programme was not allocated until this September, the last possible moment. Even with a last minute rush, E8.8m (\$9.2m) in free money was lost” (The Economist, 6.11.1999).

There have also been problems with Hungary’s commitments under the EU’s environmental protection rules:

“Hungary’s accession to the EU could be threatened if it signs an agreement with Slovakia backing the construction of new hydro dam on the Danube River” (WWF, 18.2.1998).

It is clear from the above discussion that Hungary is currently experiencing few constraints in the accession process. Hungary was perceived to be reforming too gradually at the beginning of the transition period. Yet, since then, successive Hungarian governments have maintained steady progress. Consequently, Hungary is now considered to be the most likely applicant to become the first new Eastern member of the EU.

## **Chapter 5: Evidence of Economic Constraints**

### **b) Winners and Losers?**

#### **vi) Poland**

Poland has been among the front-runners of the accession process since the beginning. But even Poland has been periodically lagging behind:

“All in all, people in Brussels who are keen on enlarging the club to the east are worried that the Poles have not seriously begun to tackle the reforms that are needed to prepare the country for membership” (The Economist, 6.6.1999).

Even Poland has problems maintaining a political constituency, despite being one of the front runners of the process:

“The EU expansion will be a slower business than the optimists used to think. Poland is certainly Central Europe’s hardest-to-handle applicant. And many more Poles are beginning to debate the merits of joining” (The Economist, 10.4.1999).

In a recent paper, the emergence of a lobby against EU accession in Poland was considered a likely outcome:

“The level of support for EU membership in Poland has traditionally been among the highest of the Central and Eastern European Applicants. This paper argues that it is likely to decrease and that the number of Polish eurosceptics will go up during the course of the accession negotiations” (Szczerbiak, 1999, p. 2).

The paper continues by demonstrating that Political Feasibility is crucially dependent on distributional effects:

“... the importance of socio-economic factors is also reflected in the strong correlation between support for or opposition to Polish EU membership and age, place of residence, education, distribution of income, assessment of personal financial prospects and certain occupations” (ibid. p. 13).

The beginnings of some discontent are becoming visible:

“In any event, the negotiations to get into the EU, and the public debate surrounding them, are clearly hotting up. Polish talk about “Europe” has become less romantic, more down-to-earth. ... . The talk is much more about the economic nuts and bolts, about how much it will cost Poland to join” (The Economist, 31.7.1999).

Furthermore, Poland is likely to present problems, because of its large agriculture sector. In March 2000 it was reported that the Commission was pushing for an agreement for the liberalisation of agricultural trade. This was seen as crucial before the beginning of the accession negotiations on the agricultural *acquis* (European Voice, 30.3.2000). Yet two weeks later, it was reported that the talks had broken down. The main issue was reported to be the lifting of agricultural duties, which were imposed by the Polish government to protect its own farmers, particularly in light of the protests the farming lobby had staged previously. After the refusal of the Polish government to lift these duties, the Commission withdrew from the talks and no solution has yet been found (Sueddeutsche Zeitung, 14.4.2000). Yet again, this shows political constraints becoming more prominent in the accession process.

There is also evidence of Uncertainty, especially in regard to the accession timetable, which has also led to noticeable economic constraints. This has also led to a reluctance of introducing costly reform, as would be predicted by the theoretical model. As Kawecka-Wyrzykowska states:

“Without a definite commitment to membership on the part of the EU, the pre-accession strategy has provided Poland and other CEE countries with little additional incentive to undertake the potentially painful reform of their regulatory regimes” (1997, p. 131).

He concludes:

“Problems still, however, exist on both sides on the way towards Poland’s accession to the EU. ... . In Poland they include - among others - greater



progress in implementation of the *acquis communautaire*, broad adjustments of the whole economy, and, above all, improvement in the competitiveness of the economy" (ibid. p.133).

"Recently the Polish coalition government was struggling to maintain unity after the finance minister introduced taxes on agricultural products" (Sueddeutsche Zeitung Online, 24.5.2000).

The Polish government has now introduced a fast track legislative process to speed up implementation of the *acquis*. In part, the system has been designed in response to the likely loss of power of the current government in the coming general election:

"The Democratic Left Alliance, expected to win both forthcoming elections by a wide margin, is also pushing Jerzy Buzek's Solidarity minority government for a greater say in Poland's accession effort" (Financial Times, 14.7.2000).

Poland is one of the First Wave countries, which has followed the Big Bang approach to transition. Despite its relatively low GDP, and the large population still dependent on agriculture for employment, Poland is one of the most advanced countries in the accession process. Yet, Poland still faces many constraints. Most notably, maintaining political feasibility of reforms remains difficult. The current crisis in government is the latest sign of the many unresolved issues for Polish accession. It thus remains to be seen whether Poland can maintain its position as a candidate for early membership.

## **Chapter 5: Evidence of Economic Constraints**

### **b) Winners and Losers?**

#### **vii) Romania**

Romania continues to lag behind the other accession candidates. The general political and economic problems of Romania have been demonstrated in a number of papers. The weak structure of the economy and the associated problems are, for example, demonstrated in a paper by Scutaru and Ghita. They consider that

“... the ownership rights are poorly defined: this implies a high degree of uncertainty” (1999, p. 2).

They further determine that

“... the political factor and its conjectural criteria substantially interferes with economic processes” (ibid.)

and show that the consequence of the presence of these key criteria

“... is an instability of the economic system” (ibid.).

Recently, Romania has experienced further political instability. In Romania the economic constraints of the reform process are easily observable. The change in government policy since the revolution has been startling. Nevertheless, these changes seem to have had little effect on the stagnant or even declining economic situation. After the revolution, from 1990 to 1996 Romania was governed by the National Salvation Front (later the Party of Social Democracy of Romania). This government was replaced in late 1997 by a coalition lead by the Democratic Convention of Romania.

The initial years after the revolution were characterised by gradual economic reform. These reforms focused initially on the liberalisation of restrictions on consumption, which were introduced by Ceaucescu. There was a move to introduce more rapid reforms when in late 1990, the gap between

domestic supply and demand started to grow untenably large. These reforms which included price liberalisation with a predictable inequality of effects on the different parts of Romanian society, led to widespread protests, which culminated in the violent demonstrations by miners in Bucharest in September 1991. These demonstrations led to the downfall of the government, demonstrating the Political Infeasibility of these rapid reforms.

The following years were characterised by further Uncertainty and political instability. The new government was seen to be committed to further reforms, but in practice, turned out to be unwilling to risk further upheavals. This demonstrates that Time Inconsistency is an important feature of Romanian politics. This kind of gradual and inconsistent approach to the reform process continued until the general election of 1996, despite changes in government.

A paper by Rachel Walker, (1998), focuses on the period of 1997-1998 in which Romania introduced Big Bang reforms partially to prepare the country for EU membership. In her paper, she analyses the “shock therapy” programme introduced in 1997 by the newly elected centre-right government. The 1997 programme contained provisions for the rapid restructuring of industry as well as privatisation and a host of other measures including further price liberalisation. These measures can be seen as pre-conditions for achieving a functioning market economy and to fulfil one of the Copenhagen Criteria. Walker comments:

“Although, the new programme seemed to provide a framework for transformation, policies suffered from inconsistencies and delay” (1998, p. 11).

These inconsistencies and delays indicate the presence of economic constraints. The expected effect of any such constraints would create economic costs, which could be substantial. The immediate effect of the reforms was an increase in inflation, which was followed by a deep recession in 1998. The effect has been a further stalling of the transformation, coupled with political instability.

In February 1999, the discontent of miners led to a violent confrontation with the government and resignations of senior Ministers (see the Economist, 6.2.1999). Later in the year, the country faced political uncertainty over the choice of the next Prime Minister. Walker comments that the economy still seems to be characterised by

"... the prevalence of the soft budget constraint in the face of mounting losses, inconsistent fiscal and monetary policy amid fears of social unrest; and persistent back-peddalling over timetables for downsizing and closing loss-making state industries" (1998, p.15).

She concludes:

"The structural reforms necessary for transformation are simply not taking place" (ibid.).

Here, we have a summary of Time Inconsistencies, Political Feasibility problems and Uncertainty leading to the delay or postponement of necessary reforms. At present the economic situation of Romania does not seem to have improved and political instability continues into the new millennium. In 1999 swift changes in the leadership of the country make the long term outlook uncertain. The crisis in 1999 created many problems, not least a high degree of Uncertainty:

"Amid all this confusion, no wonder that reform has stalled and the economy is crumbling" (The Economist, 23.1.1999).

As well as reforming the economy to be able to join the EU, Romania still faces fundamental problems in many other areas:

"The new government may well gulp at the agenda it faces. It has to get privatisation moving much faster; on some estimates, 80% of the economy is still run by the state, a figure to make the EU's jaw drop. The black economy is far too large; a way has to be found of persuading people to declare more of their income. The inefficient and corrupt civil service needs to be opened up,

and its top officials probably have to be paid better" (The Economist, 23.12.1999).

Romania's problems continue into the 21<sup>st</sup> Century. The current coalition government is facing political difficulties. After the reformist government's defeat in the June local elections, the Economist reports:

"Four years after they rejected Ion Iliescu and the left-wing populism learned at the side of his mentor, Nicolae Ceaucescu, Romanians appear ready to take him back, chiefly out of exasperation with the ruling coalition of the purportedly reforming right" (10.6.2000).

The situation has become even more serious with the President, Emil Constantinescu, deciding not to contest the forthcoming election due to the unpopularity of his party and his person. This will almost certainly lead to the election of Iliescu and power for the PDSR, made up of former communists. This will negatively affect the negotiations with the EU:

"The country had hoped to join by 2007, but a PDSR leadership could well make joining near-impossible" (The Scotsman, 19.7.2000).

Romania is still the poorest of the applicant countries. As already mentioned, in Section b) iii) it shares many problems with its neighbour, Bulgaria. Romania has suffered terribly in the last fifty years, culminating in the bloody revolution of 1989. Constraints are endemic in all sectors of society. Successive Romanian governments have not been able to maintain a time consistent approach to economic reform. There has been no political stability and the economic crisis of 1997-1998 has further undermined Romania's position. It is, thus, clear that membership, or even continuation of reform programmes is highly doubtful. This situation is summarised aptly by Daniel Daianu:

"At the end of the 1980s the Romanian economy, the country and the people presented a desolate image. After more than four decades of forced industrialisation, the competitiveness of the economy was at the bottom of the

communist league, disequilibria among sectors and shortages were increasing, the people's plight was beyond imagination; the country was imploding. Romania was a laggard among her neighbours in terms of institutional prerequisites for the post-communist transition; there was little psychological preparedness in the population for abrupt change, and almost no social base for market reforms. Moreover, the 'shock therapy' of the 1980s had created very high expectations for an immediate and substantial improvement of material conditions after a change of ruler (or of regime), which presaged a high degree of intolerance for new austerity measures. The legacy of Romanian communism was a unique economic and institutional backwardness which has seriously affected Romania's post-communist transition" (in Teichova, 1997, p. 89-90).

## **Chapter 5: Evidence of Economic Constraints**

### **b) Winners and Losers?**

#### **viii) Slovakia**

Slovakia's aspirations suffered under the Meciar government. The Meciar government was responsible for Slovakia being the only country to fail the political criterion of the EU. During the Meciar regime, policy was determined through a populist approach. The most notable Time Inconsistent policy was the reversal of the previously announced continuation of the Czechoslovakian voucher privatisation. However, many more instances of constraints could be catalogued, as described in Chapter 3 of this thesis.

After Meciar was ousted in the 1998 general election, the country's prospects of membership improved significantly. The process continued with the arrest of Meciar for alleged corruption in April 2000:

"It was either a blow for justice and an important signal, to be noted across post-communist Central Europe, that nobody is above the law. Or it was a crude act of vengeance that could polarise and destabilise Slovakian politics" (The Economist, 19.4.00).

But the removal of Meciar has not provided an easy way into the First Wave of accession countries:

"But Bratislava's plea for an early report recognising the progress made by the new administration fell on deaf ears as the Commission insisted on seeing real changes before passing judgement" (European Voice, 17.12. -6.1.1999).

With the inclusion of Slovakia in accession negotiations, the hope for a fast catch up with the First Wave countries was raised. Yet the EU has not been supportive:

"The picture was not much rosier for Lithuania, ..., or Slovakia, which was warned that it needed to improve its administration" (European Voice, 2000, p. 64).



Evidence of constraints became dominant during the reign of the Meciar government. However, the removal of Meciar from power has not resulted in its ascent into the First Wave of applicants. The 1999 Progress Report still judges Slovakia to have serious deficiencies in terms of the political and administrative structure, as well as problems of enforceability of the rule of law. It remains to be seen how far the new Slovakian government can overcome the Meciar legacy. It is, thus, unclear when Slovakia will become a member of the EU.

## Chapter 5: Evidence of Economic Constraints

### b) Winners and Losers?

#### ix) Slovenia

Slovenia belongs to the countries furthest along in the accession process. Slovenia is expected to join the EU in the near future and the reform of the communist system has been comparatively successful. However, a number of difficulties remain:

“But now, after all, it will have to dance to someone else’s tune - taking on, among other things, the EU’s *acquis communautaire*, the club’s great body (80,000 pages) of law. It will have to drop a lot of protectionist and nationalist rules of its own, including those that make it hard for Slovene companies to borrow abroad and for foreigners to buy Slovene shares” (The Economist, 6.6.1999).

Slovenia has made progress in fulfilling some of the conditions of the EU, but the EU is insisting on the almost complete adoption of the *acquis*. This leads to a situation where

“... new and onerous reforms ordered by their governments at the EU’s behest are becoming hard to bear. Opposition to the whole EU project is growing in places such as Slovenia” (The Guardian, 29.6.1999).

This has led to the virtual collapse of the coalition government in early 2000 and the possible appointment of an Argentine exile as Prime Minister, who is considered the only feasible candidate for the coalition partners on the left and right of the political spectrum (The Economist, 20.5.2000).

Slovenia has been able to avoid the legacy of violent conflict of the region. Despite being part of Yugoslavia, which disintegrated into bloody civil war in most of its territory, Slovenia managed a relatively clean break. The main constraint in the immediate aftermath of the break-up of Yugoslavia was caused by Slovenia’s historical legacy. In particular, Slovenia had to find a compromise with current EU member states on the compensation of people dispossessed after the Second World War. Since this compromise, Slovenia

has been one of the front runners of the accession process and, because of its small size and proximity to the EU, it will be among the first applicants to become a member of the EU.

## **Chapter 5: Evidence of Economic Constraints**

### **b) Winners and Losers?**

#### **x) Summary**

As identified, all of the accession countries face economic constraints in their pursuit of accession. Yet the scope and scale of the constraints varies between the different countries. While some countries seem to face few constraints, like Hungary and the Czech Republic, the situation is much more difficult in countries such as Bulgaria and Romania:

“Romanians and Bulgarians are tenaciously clutching their EU candidacies, even though they know they will not join the club in the first wave” (The Economist, 8.7.2000).

It is noticeable that the Political Feasibility constraints, Time Inconsistent policies and Uncertainty are linked strongly in those countries furthest away from accession. The link between these constraints is modelled in the previous chapter and the model demonstrates that under certain circumstances, it is likely that all of the constraints would be observed together.

The starting point of the accession process has crucially influenced the progress of each country. Those countries starting with a weak economy have not progressed as quickly as initially expected. In fact, these countries have actually fallen further behind. In addition, the initially chosen strategy has a distinct effect on the prospects of membership. In some countries the chosen strategy was pursued consistently, yet in others no clear strategy could emerge in the face of strong constraints.

The EU's transfers have also been influential in this process. Conditional transfers seem to have encouraged some of the countries, yet others have not benefited from this system. The constraints and choice strategies have interacted with historical developments and the initial years of transition to determine each applicant's unique position.

It is important to emphasise that no single part of the developments

detailed in this thesis can be considered without taking the other parts into account. While evidence of constraints is pervasive in some countries, others have fared better despite having a difficult starting point of accession. The next section will explore how this interaction might influence future developments.

## **Chapter 5: Evidence of Economic Constraints**

### **c) The Way Ahead**

The transition in the CEECs, which started with the revolutions of 1989 and 1990, is now a decade old. The countries, which overthrew communism in CEE, soon applied to the EU for full membership. Joining the most successful economic and political organisation in Europe was seen as a cornerstone of integration into a Western system based on democracy and a market economy. Yet ten years onwards, not a single one of the applicant countries has achieved membership and it is currently impossible to foresee when even the first countries will join.

The process of accession is one which is crucially important to the applicant countries. It is likely that for at least a number of countries the accession process will continue for a number of years, if not decades. Within this process, the question of constraints is crucially important. The analysis, using an economic model, has identified a number of important constraints, namely Political Feasibility, Time Inconsistency and Uncertainty. These constraints need to be addressed within the context of accession in order to pursue an optimal path to membership.

The preceding analysis in this section has shown that there is strong evidence of constraints in all of the applicant states. The Political Feasibility constraints are noticeable in the election patterns of Eastern European applicants, where, with a few exceptions, the initial reformist governments were replaced in subsequent elections by a reconstituted communist government. While, in some countries, this has not changed the orientation towards the EU, the process slowed for a number of years. In other countries, the electoral decisions have seriously hindered the accession process, most notably in Bulgaria, Romania and Slovakia. While Slovakia started among the front runners of the process (albeit behind its initial federal partner, the Czech Republic) Bulgaria and Romania already started the process behind the other applicant states. In other countries the initial position was difficult, as they

were initially members of larger, authoritarian states. This was particularly true for Slovenia and the Baltic States. Yet some of these countries initiated strong reform programmes to gain a place among the front runners. The following table links the starting point of the accession process with initial developments and emerging evidence of constraints. Such a table is, by its nature, only an indicative statement of relative position. Yet an attempt to apply an objective scale for each of the criteria has been made and the table is based on the evidence and modelling presented in previous parts of this thesis.

**Table 5.c.1: Linking developments to the current position in the accession process**

Country	Historical Starting Point	Revolutions and initial Reform	Evidence of Constraint	Current Ranking in Negotiations
Bulgaria	Very Low	Unconvincing	Very Strong	9
Czech Rep.	High	Gradual	Serious	5
Estonia	Low	Big Bang	Some	4
Hungary	High	Gradual	Few	1
Latvia	Low	Changeable	Some	6
Lithuania	Low	Changeable	Serious	7
Poland	Medium	Big Bang	Serious	3
Romania	Very Low	Unconvincing	Very Strong	10
Slovakia	Medium	Unconvincing	Strong	8
Slovenia	High	Changeable	Few	2

To illustrate the relationship between the developments and the current position in the accession process, a rank is assigned to each qualitative statement in the previous table.

**Table 5.c.2: Scoring and ranking the qualitative statements**



Country	Historical Starting Point	Revolutions and initial Reform	Evidence of Constraint	SUM
Bulgaria	3	3	4	10
Czech Rep.	0	1	2	3
Estonia	2	0	1	3
Hungary	0	1	0	1
Latvia	2	2	1	5
Lithuania	2	2	2	6
Poland	1	0	2	3
Romania	3	3	4	10
Slovakia	1	3	3	7
Slovenia	0	2	0	2

The sum of the ranked qualitative statements is now contrasted to the current position in the accession process. The following table shows this relationship.

**Table 5.c.3: Ranks of developments and position in the accession process compared**

Country	SUM	RANK	Current Ranking in Negotiations	Comparison
Bulgaria	10	=9	9	Similar
Czech Rep.	3	=3	5	Similar
Estonia	3	=3	4	Similar
Hungary	1	1	1	Identical
Latvia	5	6	6	Identical
Lithuania	6	7	7	Identical
Poland	3	=3	3	Similar
Romania	10	=9	10	Similar
Slovakia	7	8	8	Identical
Slovenia	2	2	2	Identical

The table shows that the current position of the applicant countries is crucially determined by a combination of the different developments and not a single isolated policy. In particular, the starting point of the accession process, given by previous historical development, the strategy of the applicant country chosen after the revolutions and the constraints the countries face, combine to determine the position of the applicant in the accession process. These developments are inter-related, yet it is clear that by regarding only one of the aspects of the accession process, no accurate picture can be formed.

It is thus clear that the way forward is determined by current strategy, including the influence the EU can assert over the process. Yet it is impossible to disregard the previous development which will, to a large degree, determine the success of any such strategy. The distance from membership needs to be addressed in the context of these countries' positions and there is

no single accession strategy which will fit every country at every stage of development.

In particular, those countries furthest away from membership need to reassess their position in the accession process. The need to develop a gradual strategy to overcome constraints and an unfavourable starting position is paramount. The EU can encourage this process by not insisting on reforms for membership but rather by freeing substantial transfers without conditionality. If these issues are not addressed it is likely that the constraints will become more prominent in those countries furthest away from membership, most notably Romania and Bulgaria. As a result, the accession process will become more and more costly for these countries and might eventually lead to the abandonment of EU membership aspirations.

## CONCLUSIONS

The thesis has examined the accession process by combining different methodologies from political science, historical examination and economic modelling. This has enabled a complete examination of the process of accession, which is dominating policy considerations in CEE. The historical examination in Chapter 2 has determined the starting point of accession, demonstrating that some of the CEECs started the transition process from a disadvantaged position. This is most notably the case for the Balkan and Baltic applicants. Chapter 3 has demonstrated that the policies pursued by the applicants after the revolutions have seriously influenced their current position in the accession process, with countries pursuing 'Big Bang' strategies, like Estonia and Poland, faring better than countries which have delayed reform, such as Bulgaria and Romania. The political analysis has also shown that political uncertainty can be a crucial set-back in the pursuit of accession, with Slovakia being the most notable example. Finally, economic modelling, as explored in Chapter 4, provides a framework in which both the constraints these countries face and the interaction between these constraints can be understood. The theoretical analysis indicates that there will be strong evidence of all of the constraints in those countries furthest from accession.

These constraints modelled by the economic analysis in Chapter 4 of this thesis, can be observed repeatedly in the accession process. The constraints are in evidence in all of the applicant countries but, in particular, they can be observed in those countries furthest away from accession, as demonstrated in Chapter 5. In these countries, most notably Bulgaria and Romania, Political Feasibility problems have already caused political instability. The persistent Uncertainty associated with the accession process together with Time Inconsistent strategies caused by the lack of credible pre-commitment mechanisms, have imposed substantial costs on these countries. As the awareness of the length of the accession process becomes more prevalent, these constraints will be even more binding. For these countries, a

reassessment of their situation in relation to the EU must occur. In particular, the conditionality of the Copenhagen criteria will become weaker as the desired membership fails to materialise.

The EU must reconsider the strategy towards those countries. The switch to more substantial transfers not linked to accession criteria must be considered for those applicants furthest from accession. If these changes in policy do not occur, the current accession process could undermine the final goal - the full membership of the EU. The accession process is in danger of ending up as a perpetual negotiation for these countries, instead of a stepping stone towards full membership.

The historical development of these countries has crucially influenced the current situation. It is clear that those countries starting from a disadvantaged position have found it very difficult to overcome the initial problems. This is linked to the strategy these countries chose in pursuing reform, which has also crucially influenced their current position. In this context, this type of analysis can be applied to those countries in CEE, which have not yet applied to the EU but face a similar transition process. This application of the analysis could give an indication of how far these countries are from accession and how they stand in relation to each other. This could even include countries such as Byelorussia, Russia, and the Ukraine. President Clinton, on his recent visit to Europe, recommended that no door should be closed for Russia - neither NATO nor the EU (Spiegel Online, 5.6.2000). However, it has been noted that some countries, most notably the Ukraine, are left out of the current accession negotiations. This has even resulted in the Eastern border of current accession candidates being termed as being behind a 'Belgian Curtain', imposed by the Commission (Scotsman, 25.7.2000). The extension of the analysis to these states, whilst feasible, is beyond the scope of this thesis.

The analysis has combined the different historical, economic and political elements, with an explicit modelling approach, to show the current respective positions of the applicant countries. This analysis can be extended

into the future. The following table shows the prospects and timing of the applicant, assuming that no major changes in policy and economic trends take place.

**Table C.1: Prospects and Timing for EU membership**

	Prospects for EU membership	Timing
Hungary	No major constraints	Near Future
Slovenia	No major constraints	Near Future
Estonia	Some problems to be resolved	Near Future- Medium Term
Poland	Some problems to be resolved	Near Future- Medium Term
Czech Rep.	Some problems to be addressed	Medium Term
Latvia	Faster progress necessary	Medium Term- Long Term
Slovakia	Faster progress necessary	Medium Term-Long Term
Lithuania	Major problems not addressed	Long Term
Bulgaria	Progress doubtful	Long Term- Not foreseeable
Romania	Progress doubtful	Long Term- Not foreseeable

The analysis has demonstrated that for some countries, fast accession is a distinct possibility, namely Estonia, Hungary and Slovenia. The Czech Republic and Poland still have to overcome many constraints, but are likely to join the EU in the foreseeable future. A number of countries can only expect membership in the medium or long term, namely Latvia and Slovakia. For others, namely Bulgaria and Romania, the position is even more difficult, with the prospect of membership being doubtful even in the long term. It is interesting to note in this context, that a frequent argument for membership has been a need to stabilise the political situation in CEE. This argument would suggest that those countries furthest from membership should be given precedence, contrary to the current position in membership negotiations.

The thesis has thus combined historical development with the transition period and economic modelling to develop a complete picture of

the current position of the applicant countries. The combination of this analysis with current evidence has demonstrated that some of the applicant countries are close to accession with few problems expected, while for those furthest from membership, the situation is becoming increasingly difficult and their membership is becoming a doubtful proposition.



# APPENDIX A

The tables in Annex A have been constructed to derive numerical results for Chapter 4, section g. The numerical simulation determines the effects of all variables on the choice variables and on residual uncertainty, as well as combined welfare. Annex A illustrates numerical values of the effect of uncertainty in case of overall positive reforms.

The notation of the tables is as follows:

$$\beta = b$$

$$\sigma = s$$

$$\lambda = l$$

$$\chi = a$$

The notation for W, R, f and M is unchanged.

bn refers to different values of b, where b1 represents an increasing series from 0.1 to 1, with steps of 0.1, and b2 to b4 represent a different fixed value of b. fn refers to different values of f, where f1 represents an increasing series from 0.25 to 10, with irregular steps, and f2 to f4 is derived from different fixed value of b.

Table A.1 shows the different combinations of b and f used to illustrate the effect of different residual uncertainties and different benefit differentials between the EU and the CEECs

**Table A.1: Different values for bn and fn**

b1	b2	b3	b4	f1	f2	f3	f4
0.1	0.1	0.5	1	0.25	0.5	1	4
0.2	0.1	0.5	1	0.5	0.5	1	4
0.3	0.1	0.5	1	0.75	0.5	1	4
0.4	0.1	0.5	1	1	0.5	1	4
0.5	0.1	0.5	1	2	0.5	1	4
0.6	0.1	0.5	1	3	0.5	1	4
0.7	0.1	0.5	1	4	0.5	1	4
0.8	0.1	0.5	1	6	0.5	1	4
0.9	0.1	0.5	1	8	0.5	1	4
1	0.1	0.5	1	10	0.5	1	4

Table A.2 shows different values of M and R where M1 and R1 are used to determine s, l, a and W in the right hand columns. s, l and a are derived from the initial values to determine welfare, W. The table shows that only if R is larger than M, welfare is positive. M2 and R2 are used in the following tables to determine similar welfare results. Mn refers to different values of M, where M1 represents an increasing series from 10 to 200, with irregular steps, and M2 represents a fixed value of M. Rn refers to different values of R, where R1 represents an decreasing series from 50 to 1, with irregular steps, and R2 represents a fixed value of R.

**Table A.2: Different values for M and R and resulting s, l, a and W**

M1	R1	M2	R2	s(M1,R1)	l(M1,R1)	a(M1,R1)	W(M1,R1)
10	50	90	10	1	-0.55555	-0.55555	-38.8888
20	35	90	10	1	-0.7	-0.7	-52.5
30	30	90	10	1	-1	-1	-90
40	25	90	10	1	-2.5	-2.5	-262.5
50	20	90	10	1	2	2	240
70	17	90	10	1	0.47222	0.47222	74.1388
90	14	90	10	1	0.22580	0.22580	43.8064
120	10	90	10	1	0.1	0.1	25
150	6	90	10	1	0.04347	0.04347	13.3043
200	1	90	10	1	0.00505	0.00505	2.02525

Table A3 shows resulting values of s resulting from different combinations of b and f. The equilibrium levels of s and d are calculated, in Table A.3 and A.4, which are denoted by  $s(b_n, f_n)$  and  $d(b_n, f_n)$ . For these R2 and M2 are used in the calculation.

**Table A.3: Resulting values of s**

s1(b2,f1)	s2(b3,f1)	s3(b4,f1)	s4(b1,f2)	s5(b1,f3)	s6(b1f4)
40	8	4	20	10	2.5
20	4	2	10	5	1.25
13.3333	2.66666	1.33333	6.66666	3.33333	0.83333
10	2	1	5	2.5	0.625
5	1	0.5	4	2	0.5
3.33333	0.66666	0.33333	3.33333	1.66666	0.41666
2.5	0.5	0.25	2.85714	1.42857	0.35714
1.66666	0.33333	0.16666	2.5	1.25	0.3125
1.25	0.25	0.125	2.22222	1.11111	0.27777
1	0.2	0.1	2	1	0.25

Table A.4 shows the resulting values of l.

**Table A.4: Resulting values of l**

l1	l2	l3	l4	l5	l6
-0.14084	-0.28571	1	-0.32258	-0.90909	2.5
-0.32258	2	0.2	-0.45454	-5	0.76923
-0.56603	0.54545	0.15789	-0.76923	1.42857	0.45454
-0.90909	0.4	0.14285	-2.5	0.625	0.32258
-10	0.28571	0.125	2	0.4	0.25
4.28571	0.26086	0.12	0.71428	0.29411	0.20408
2.5	0.25	0.11764	0.43478	0.23255	0.17241
1.76470	0.24	0.11538	0.3125	0.19230	0.14925
1.53846	0.23529	0.11428	0.24390	0.16393	0.13157
1.42857	0.23255	0.11363	0.2	0.14285	0.11764

The derived values of l and s are multiplied with each other and b to arrive at the probability a that a reform does happen.

**Table A.5: Resulting values of a**

a1	a2	a3	a3	a5	a6
-0.56338	-1.14285	4	-0.64516	-0.90909	3.125
-0.64516	4	0.4	-0.90909	-2.5	0.48076
-0.75471	0.72727	0.21052	-1.53846	0.47619	0.18939
-0.90909	0.4	0.14285	-5	0.15625	0.10080
-5	0.14285	0.0625	4	0.08	0.0625
1.42857	0.08695	0.04	1.42857	0.04901	0.04251
0.625	0.0625	0.02941	0.86956	0.03322	0.03078
0.29411	0.04	0.01923	0.625	0.02403	0.02332
0.19230	0.02941	0.01428	0.48780	0.01821	0.01827
0.14285	0.02325	0.01136	0.4	0.01428	0.01470

Table A6 shows the resulting values for welfare, showing that certain combinations of the choice values can produce negative welfare, while welfare values can peak at other combinations. Table A.6 uses the previously derived values to calculate aggregate welfare. The effect of changes in M and R is calculated by using M1 and R1. For simplicity b4 and f3 are used as the fixed values in this calculation. Table A.6 thus shows the resulting values for W.

**Table A.6: Results of the numerical analysis in terms of Welfare**

W1	W2	W3	W4	W5	W6
-678.732	-290	580	-406.129	-344.545	569.375
-406.129	670	52	-303.636	-840	116.009
-342.830	117.272	32.6315	-366.923	163.968	61.1994
-344.545	70	27.1428	-965	59.2187	42.4848
-1640	40	22.1875	670	34.8	33.4375
538.571	35.2173	21.2	217.142	25.0326	28.2043
281.875	33.4375	20.8088	123.664	20.1091	24.8267
183.529	32	20.4807	85	17.2716	22.4795
155.673	31.3970	20.3392	64.4715	15.4847	20.7598
142.857	31.0697	20.2613	52	14.2857	19.4485

**APPENDIX B**

The tables in Annex B have been constructed to derive further results for Chapter 4, section g. The numerical simulation determines the effects of all variables on the choice variables and on residual uncertainty, as well as combined welfare. Annex B illustrates numerical values of the effect of uncertainty in case of conditional transfers.

The notation of the tables is as follows:

$\beta = b$

$\sigma = s$

$\lambda = 1$

$\chi = a$

The notation for W, R, f and M is unchanged.

bn refers to different values of b, where b1 represents an increasing series from 0.1 to 1, with steps of 0.1, and b2 to b4 represent a different fixed value of b. fn refers to different values of f, where f1 represents an increasing series from 0.25 to 10, with irregular steps, and f2 to f4 represent a different fixed value of b.

Table B.1 shows the different combinations of b and f used to illustrate the effect of different residual uncertainties and different benefit differentials between the EU and the CEECs



**Table B.1: Different values of bn and fn**

b1	b2	b3	b4	f1	f2	f3	f4
0.1	0.1	0.5	1	0.25	0.1	0.25	0.5
0.2	0.1	0.5	1	0.5	0.1	0.25	0.5
0.3	0.1	0.5	1	0.75	0.1	0.25	0.5
0.4	0.1	0.5	1	1	0.1	0.25	0.5
0.5	0.1	0.5	1	2	0.1	0.25	0.5
0.6	0.1	0.5	1	3	0.1	0.25	0.5
0.7	0.1	0.5	1	4	0.1	0.25	0.5
0.8	0.1	0.5	1	6	0.1	0.25	0.5
0.9	0.1	0.5	1	8	0.1	0.25	0.5
1	0.1	0.5	1	10	0.1	0.25	0.5

In Table B.2, Mn refers to different values of M, where M1 represents an increasing series from 10 to 200, with irregular steps, and M2 represents a fixed value of M. Rn refers to different values of R, where R1 represents an decreasing series from 50 to 1, with irregular steps, and R2 represents a fixed value of R.

**Table B.2: Different values of M and R and resulting s, l, a and W**

M1	R1	M2	R2	s(M1,R1)	l(M1,R1)	a(M1,R1)	W(M1,R1)
10	50	90	10	3.8875	0.125	0.48593	-43.8115
20	35	90	10	3.67857	0.125	0.45982	-22.8515
30	30	90	10	3.4375	0.125	0.42968	-12.1728
40	25	90	10	3.1	0.125	0.3875	-1.96875
50	20	90	10	2.59375	0.125	0.32421	7.40478
70	17	90	10	1.68382	0.125	0.21047	17.8833
90	14	90	10	0.38392	0.125	0.04799	24.4521
120	10	90	10	-2.75	0.125	-0.34375	20.7031
150	6	90	10	-10.0625	0.125	-1.25781	-27.6064
200	1	90	10	-108.5	0.125	-13.5625	-1106.46

The equilibrium levels of s and d are calculated in Table B.3 and B.4, which are denoted by  $s(bn,fn)$  and  $d(bn,fn)$ . For these R2 and M2 are used in the calculation.

**Table B.3: Resulting levels of s**

s1(b2,f1)	s2(b3,f1)	s3(b4,f1)	s4(b1,f2)	s5(b1,f3)	s6(b1f3)
0.2875	1.8875	3.8875	0.895	0.2875	0.075
-0.15714	0.64285	1.64285	1.7	0.47857	0.04285
-0.55416	-0.02083	0.64583	2.475	0.6375	-0.025
-1.1	-0.7	-0.2	3.16	0.7	-0.2
-2.45	-2.25	-2	3.6875	0.59375	-0.5625
-5.11372	-4.98039	-4.81372	3.83823	0.08382	-1.37352
-9.61785	-9.51785	-9.39285	3.625	-0.81607	-2.61785
-23.9833	-23.9166	-23.8333	1.7	-3.55	-5.9
-62.4875	-62.4375	-62.375	-4.125	-10.4625	-13.825
-599.99	-599.95	-599.9	-95	-108.5	-123

Similarly, we can calculate the resulting level of l, as shown in Table B.4.

**Table B.4: Resulting levels of l**

l1	l2	l3	l4	l5	l6
0.125	0.125	0.125	0.05	0.125	0.25
0.25	0.25	0.25	0.05	0.125	0.25
0.375	0.375	0.375	0.05	0.125	0.25
0.5	0.5	0.5	0.05	0.125	0.25
1	1	1	0.05	0.125	0.25
1.5	1.5	1.5	0.05	0.125	0.25
2	2	2	0.05	0.125	0.25
3	3	3	0.05	0.125	0.25
4	4	4	0.05	0.125	0.25
5	5	5	0.05	0.125	0.25

These results from B.3 and B.4 are then multiplied with each other and b to arrive at the probability a that a reform does happen, as shown in Table B.5.

**Table B.5: Resulting levels of a**

a1	a2	a3	a3	a5	a6
0.00359	0.11796	0.48593	0.00447	0.00359	0.00187
-0.00392	0.08035	0.41071	0.017	0.01196	0.00214
-0.02078	-0.00390	0.24218	0.03712	0.02390	-0.00187
-0.055	-0.175	-0.1	0.0632	0.035	-0.02
-0.245	-1.125	-2	0.09218	0.03710	-0.07031
-0.76705	-3.73529	-7.22058	0.11514	0.00628	-0.20602
-1.92357	-9.51785	-18.7857	0.12687	-0.07140	-0.45812
-7.195	-35.875	-71.5	0.068	-0.355	-1.18
-24.995	-124.875	-249.5	-0.18562	-1.17703	-3.11062
-299.995	-1499.87	-2999.5	-4.75	-13.5625	-30.75

Using this value and the previously derived values, welfare for the applicant is calculated. The effect of changes in M and R is calculated by using M1 and R1. For simplicity b4 and f3 are used as the fixed values in this calculation.

**Table B.6: Results of the numerical analysis in terms of Welfare (EE)**

WEE1	WEE2	WEE3	WEE4	WEE5	WEE6
18.7087	15.2188	45.0001	5.99280	18.7087	31.9201
33.7240	33.8201	59.7831	-0.681	17.5983	32.2652
47.5365	43.6075	60.6526	-5.98990	17.1789	32.5817
61.655	47.475	48.2	-9.41488	17.645	32.74
108.452	46.5625	-20	-10.6787	18.8726	32.1923
166.327	44.6597	-109.136	-9.09950	20.9828	30.5225
298.063	334.467	357.729	-5.73203	23.5668	29.4403
1597.88	5870.52	11124.1	4.776	37.4025	54.92
14364.0	67724.4	134164.3	46.7007	143.089	320.837
1779400.3	8869970.8	17730504.5	5049.5	14600.9	36317.5

Similarly we can derive the value for welfare for the European Union.

**Table B.7: Results of the numerical analysis in terms of Welfare (EU)**

WEU1	WEU2	WEU3	WEU4	WEU5	WEU6
0.00449	0.14746	0.60742	0.00223	0.00449	0.00468
-0.01964	0.40178	2.05357	0.017	0.02991	0.01071
-0.23378	-0.04394	2.72460	0.05568	0.08964	-0.01406
-1.1	-3.5	-2	0.1264	0.175	-0.2
-12.25	-56.25	-100	0.23046	0.23193	-0.87890
-80.5411	-392.205	-758.161	0.40301	0.05500	-3.60551
-346.242	-1713.21	-3381.42	0.57093	-0.80332	-10.3078
-2590.2	-12915	-25740	0.408	-5.325	-35.4
-14997	-74925	-149700	-1.39218	-22.0693	-116.648
-299995	-1499875	-2999500	-47.5	-339.062	-1537.5

Finally, we can thus derive aggregate welfare, as demonstrated in Table B.8. Again, the results show a wide degree of variation, from negative values of aggregate welfare to high positive values.

**Table B.8: Results of the numerical analysis in terms of Welfare (Total)**

W1 Total	W2 Total	W3 Total	W4 Total	W5 Total	W6 Total
18.7132	15.3663	45.6076	5.99503	18.7132	31.9248
33.7043	34.2219	61.8367	-0.664	17.6282	32.2759
47.3027	43.5636	63.3772	-5.93421	17.2686	32.5676
60.555	43.975	46.2	-9.28848	17.82	32.54
96.2025	-9.6875	-120	-10.4482	19.1046	31.3134
85.7860	-347.546	-867.298	-8.69648	21.0378	26.9170
-48.1793	-1378.74	-3023.69	-5.16109	22.7635	19.1325
-992.315	-7044.47	-14615.8	5.184	32.0775	19.52
-632.924	-7200.54	-15535.6	45.3085	121.019	204.189
1479405.3	7370095.8	14731004.5	5002	14261.8	34780

## GLOSSARY OF TERMS AND ABBREVIATIONS

<i>Acquis Communautaire</i>	Body of law of the European Union
Agenda 2000	Strategy paper by the Commission detailing how to prepare for accession
Apparatchiks	Communist bureaucrats
Applicant Countries	Countries having applied to join the EU
Amsterdam Treaty	Latest EU Treaty (1995)
AWS	Solidarity Action Programme (Poland)
Baltic States	Estonia, Latvia and Lithuania
Big Bang Now (BBL)	Introducing all necessary reforms as late as possible
Big Bang Now (BBN)	Introducing all necessary reforms immediately
Breshnev Doctrine	Doctrine that Soviet hegemony in CEE would be backed up by force if necessary
BSP	Bulgarian Socialist Party
CAP	Common Agricultural Policy
CEE	Central and Eastern Europe
CEECs	Central and Eastern European Countries
CEFTA	Central European Free Trade Association
Council	Legislative of the EU



COMECON	Council of Mutual Economic Assistance - Trade agreement between CEE and the SU
Commission	Executive of the EU
Common Market	Free movement of people, capital, goods and services within the EU, established in 1992
CPEs	Centrally Planned Economies
DCR	Democratic Convention of Romania
DPS	Democratic Party Saimnieks - The Master (Latvia)
<i>De novo</i> enterprises	Newly created private enterprises
DNSF	Democratic National Salvation Front (Romania), later PSDR
ECJ	Court of Justice of the European Communities
ECP	Estonian Coalition Party
ECU	European Currency Unit
EEC	European Economic Community
EMU	Economic and Monetary Union
EP	European Parliament
ERDF	European Regional Development Fund

ESF	European Structural Funds
EU	European Union
Euroland	Those countries participating in the Single European Currency - the Euro
Europe Agreements	Trade Agreements between the EU and the applicant countries
European Council	Meeting of the EU heads of government and foreign ministers to decide strategy
FDI	Foreign Direct Investment
First Wave	Countries designated as front runners by the European Commission
FYD- HCP	Federation of Young Democrats - Hungarian Civic Party
FYROM	Former Yugoslav Republic of Macedonia
GB	Great Britain
GDR	German Democratic Republic (East Germany)
Glasnost	Removal of press censorship (Soviet Union)
Gradualism (GRAD)	Introducing all necessary reforms sequenced over time
Great War	First World War
HDF	Hungarian Democratic Forum

HSP	Hungarian Socialist Party
Hungarian Uprising	Uprising against communist rule in 1956
IGC	Inter-Governmental Conference
Latvian Way	Initial Latvian opposition
LDP	Liberal Democratic Party (Slovenia)
LFU	Latvian Farmers Union
LDLP	Lithuanian Democratic Labour Party
IMF	International Monetary Fund
Maastricht Treaty	EU Treaty establishing EMU (1991)
MDS	Movement for Democratic Slovakia
MEPs	Members of the European Parliament
MRF	Muslim Movement for Rights and Freedom (Bulgaria)
NATO	North Atlantic Treaty Organisation
Nordic Countries	Denmark, Finland, Norway and Sweden
NSF	Council of the National Salvation Front (Romania)
NTB	Non Tariff Barriers
OMON	Special Forces of the interior ministry (Soviet Union)

Open Forum (OF)	Czechoslovakian Opposition Movement
OST	Optimal Speed of Transition
Ostpolitik	Policy by German Social-Democrats to open up the relationship with East Germany
Perestroika	Economic liberalisation programme (Soviet Union)
PHARE	Economic assistance for CEE by the EU
Prague Spring	Reform programme initiated in Czechoslovakia in 1968
Pro Partia Party	Initial opposition in Estonia
Protectorate of Bohemia & Moravia	The Nazi occupied areas of what now constitutes the Czech Republic
PSBR	Public Sector Borrowing Requirement
PSDR	Party of Social Democracy of Romania
QMV	Qualified Majority Voting
Sajudis	Initial Lithuanian opposition
SDL	Democratic Left Alliance (Poland)
Second Wave	Countries designated as lagging behind the front runners by the European Commission
Securitate	Communist secret police (Romania)
Sejm	Polish lower parliamentary chamber

Solidarnosc	Solidarity (Polish Independent Trade Union, later a democratic party)
SU	Soviet Union
Treuhandanstalt	German privatisation agency
UD	Democratic Union (Poland)
UN	United Nations
UDF	United Democratic Front (Bulgaria)
US	United States of America
USSR	Union of Socialist Soviet Republics
Visegrad countries	Initial CEFTA members (signed in 1992 by Czechoslovakia, Poland and Hungary)

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